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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1984

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

FEBRUARY 8 AND 9, 1984

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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CONTENTS

WEDNESDAY, FEBRUARY 8, 1984

Page

Opening statement of Chairman Garn 1
Opening statement of Senator Proxmire 2

WITNESSES

Paul A. Volcker, Chairman, Board of Governors, Federal Reserve System 3
1983 actual growth on target 4
Foreign trade deficit 5
Protectionism in the foreign trade situation 6
Prepared statement 8
Monetary policy targets for 1984 and economic projections 8
The opportunity and the risks 11
Sources of strength 13
The problems 16
The implications for monetary policy 21
Toward a positive solution 26
Tables:
Table I: Federal Reserve objectives for money and credit growth in 1984 30
Table II: Federal Reserve objectives for money and credit in 1983 and actual growth 30
Charts:
Chart 1: Ranges and actual money and credit growth (M_1) 31
Chart 2: Ranges and actual money growth (M_2, M_3) 32
"Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" 33
Budget cuts could have favorable climate on economy 88
Implementation of contemporaneous reserve accounting 90
OMB projections show nominal decline in GNP 92
Need to improve horrendous trade imbalance 94
Presidential line item veto power 96
Country needs to overcome trade deficit 98
Reduce defense spending and increase revenues 100
Hefty corporate profits anticipated 101
Savings recommendations needed 104
Hope for bipartisan compromise 106
Effects of the inflow of foreign capital 108
$50 billion figure seems realistic 110
Risks of putting off legislation until 1985 113
Restrained wage settlements and reduced prices 115
Decline of corporate taxes 119
Tax increases have never solved the deficit problem 122
Shift in tax structure could be useful 125
United States on verge of being international debtor 128
Revenue sharing with States 130
Response to written questions of Senator Riegle 132

THURSDAY, FEBRUARY 9, 1984

Opening remarks of Chairman Garn 143

WITNESSES

	Page
Beryl Sprinkel, Under Secretary for Monetary Affairs, Department of the Treasury	143
Prepared statement	144
The progress in reducing inflation	145
The importance of a longrun commitment to price stability	150
The problem of monetary variability	154
Improving monetary control	157
Conclusion	160
Charts:	
Chart 1: Money leads inflation by 2 years	161
Chart 2: Short-term and long-term interest rates	162
Chart 3: Comparative behavior of interest rates and monetary volatility	163
Chart 4: Correlation between money growth and real GNP	164
Reason for slowdown in money growth	165
Discussion on Secretary Sprinkel's charts	167
Improvement in the inflation rate	169
Gradual slowing of rate of growth	172
Slow growth could lead to another recession	175
Overvaluation of the dollar	178
Response to written question of Senator Proxmire	180
Martin Feldstein, Chairman, Council of Economic Advisers	181
Prepared statement	182
Monetary policy, budget deficits, and the economic outlook	183
Monetary policy	183
Budget deficits	189
Spending cuts\must accompany tax increase	191
Tax revenue should be proportional with GNP	193
Growth rate of 4 percent is projected	194
Major corporations having good revenues in 1983	197
Robert Parry, executive vice president and chief economist, Security Pacific Corp., Los Angeles, Calif	199
Prepared statement	200
The economy in 1983	200
Stabilization policies	202
Fiscal policy	202
Monetary policy	203
Prospects for the economy	205
Concluding comments	206
Tables:	
Table I: Selected economic indicators	208
Table II: Selected components of the Consumer Price Index	208
Table III: Prospects for the U.S. economy	209
Allan H. Meltzer, professor, Carnegie-Mellon University, Pittsburgh, Pa	210
Prepared statement	211
What is our monetary policy?	211
Table 1: Targets for M_1 growth 1976–83	212
Chart 1: Monetary variability and GNP fluctuations	213
Panel discussion:	
Can the Federal Reserve hit the 1-percent target	218
Relational issue of deficits and interest rates	220
Four budget items cause 80 percent of the deficit	222
Politicizing the Federal Reserve	224

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1984

WEDNESDAY, FEBRUARY 8, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Mattingly, Hecht, Humphrey, Proxmire, Riegle, Dixon, Sasser, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

On Monday of this week the Federal Reserve announced a major upward revision to the money growth numbers for the second half of 1983, but even with this revision money growth slowed markedly during the third and fourth quarters.

On Monday, the Federal Reserve also announced 1984 target ranges for growth in M_1, M_2, and M_3 that are lower than the 1983 targets.

In accordance with the Humphrey-Hawkins Act which requires these hearings to be held on a semiannual basis, our principal responsibility this morning is to assess the appropriateness of these two developments. The second responsibility, of course, is to examine the entire context in which monetary policy must operate. I certainly understand Chairman Volcker that as we trade with the House over who is first to hold these hearings that they become rather anticlimactic the second time around.

Nevertheless, it's important that each body have an opportunity to question you during these hearings or your conduct of monetary policy. As I have said so many times when you have been here before, we must include, in my opinion, discussion of the deficits that must be dealt with no matter who is Chairman of the Federal Reserve or what the policies are in the Federal Reserve. Never in the history of this country has the Federal Reserve Board had to deal with deficits of the size that we are now forcing on the country. When I say we, I mean the Congress of the United States. I think we have to consider them together. To do otherwise, to assert that all you have to do is push some button and control of the MS will take care of it all, that is an insult, at least to this Senator's intelligence. That we can have $200 billion deficits, carry a $1.4 trillion debt, have interest on that debt in excess of $130 billion—

which exceeds by $24 billion the entire budget of John Kennedy for 1962 to run the entire country and defend it just 22 years ago—just amazes me. We can't try and shift all of the burden away from that and indicate that we have no responsibility whatsoever in this body.

I, for one, do not believe that we can ever solve this problem until there is better coordination between fiscal and monetary policy. That certainly means that Congress has got to do a great deal better job. The evidence is absolutely clear that, as these deficits continue to mount, that is our responsibility and no one else's.

The Constitution is very clear on who has the responsibility and the obligation in our three-part system of government for appropriations. The Constitution does not allow the Federal Reserve to appropriate money. It does not allow the President to appropriate money. And it's time that the Congress started matching its rhetoric with its votes. I don't know of any fiscal liberals any more and certainly not in the Senate. Everybody is for reduced deficits. It is the big topic. And I would suggest that the American people this fall ought to go home and look at their Senators and Congressmen and see if their rhetoric matches their voting records and if it does not, then I suggest they get somebody else to represent them.

Anyway, we are pleased to have you before us once again to discuss monetary policy.

Senator Proxmire, do you have any comments you wish to make before the Chairman begins?

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Well, I'll just make a slight political rejoinder. I have got admiration, respect, and affection for our distinguished Chairman. First, I'd like to say, as I said when you came before this committee for confirmation—and we recommended your confirmation, Chairman Volcker—I said, "Alas, poor Volcker," and I say it again with more emphasis today because of the terrible budget the President of the United States has sent to us.

The fact is, in the last couple years the Congress has not significantly exceeded the President's request for spending. We have shifted it a little bit, exceeded it by maybe 1 percent last time. But the President must take the initiative. The President and the Congress have to work together on the kind of spending we engage in. The President has sent us a $180 billion monstrosity from which his advisers seem to be backing away—even Secretary Regan yesterday said we've got to do something with that. The budget is the President's document, it is what he has asked us to do, it is a fundamental priority document of this country and I think we have to work with it. But I don't think that the President or the Congress should escape unscathed, and this is certainly—we're both sinners, grievous sinners, and I hope that St. Paul will help us move out of this terrible purgatory we find ourselves in.

The CHAIRMAN. Well, certainly the President sent us a budget that I don't like. I don't like the recommendations, but I think the Senator misses my point. It doesn't matter what this President or any other President sends us; we don't have to accept it. Congress is the only one under the Constitution that can appropriate, and to

lay it back to this President or any other is wrong. We don't like these recommendations. That's where we need to separate the rhetoric from our votes. We can totally reject it. We can start with our own budget. We can ignore it. Congress has not done so with this President or the other two Presidents that I have served with since I have been here and I would suspect—not suspect, I know you have served with far more Presidents than I have, and the same has been true.

In most years Congress has spent far more than Presidents have recommended, but we do need to get our house in order.

Before I turn to other Senators for any opening comments they would like to make, I would like to welcome to the committee a new member. Senator Humphrey is the newest member and sits on the far right, where I started from many years ago. It's a good seat and it takes a little while to work around, but we are very happy to have you on the committee, Senator Humphrey, and although this is a violation of our rules of seniority, because you are brand new, I think I will turn to you first to see if you have any comments that you would like to make.

Senator PROXMIRE. Would the chairman yield?

The CHAIRMAN. Yes.

Senator PROXMIRE. Just to make this bipartisan, I want to welcome Senator Humphrey too, especially in view of the fact that this subject is so appropriate for Senator Humphrey. There's nobody who's been more of a bearcat in trying to hold down spending than Gordon Humphrey and I'm grateful to have Senator Humphrey on the committee.

Senator HUMPHREY. In that vein, does anybody else have any compliment they want to make? [Laughter.]

Thank you, Mr. Chairman. I am glad to be here. When do I get a permanent name tag?

The CHAIRMAN. Give us a day or two and we'll have one made for you.

Rather than going down the line, are there any other members of the committee who wish to make an opening statement? Obviously, after the Chairman has finished his comments we will have questions. Senator Heinz, do you have anything?

Senator HEINZ. Well, I was told we are going to lose our name tags if we do, Mr. Chairman. No, I don't have an opening statement.

The CHAIRMAN. Senator Dixon.

Senator DIXON. I have nothing, Mr. Chairman.

The CHAIRMAN. Any others?

[No response.]

The CHAIRMAN. Mr. Chairman, the floor is yours, at least temporarily.

STATEMENT OF PAUL VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, you have the statement that I delivered before the House Committee yesterday. I won't read that, but I might just make some of the points in it in a somewhat different order briefly.

1983 ACTUAL GROWTH ON TARGET

As far as monetary growth is concerned, we ended 1983 pretty much on target in terms of actual growth compared with target ranges.

We have subsequently revised some of the figures, as you indicated, and the benchmarks we have issued are fractionally higher on all the monetary aggregates, with M_3 for the fourth quarter slightly above the target range. The other aggregates were well within the target range after revision. That did occur with slower growth in the second half of the year, as you indicated.

The other side of that slower growth in the aggregates during the second half of the year while the economy was continuing to grow was generally rising velocity. I point that out because we went through about 18 months of an abnormally sharp decline of velocity for a variety of reasons analyzed in our Humphrey-Hawkins report.

As we look at the situation now, and in setting the new targets for 1984, we see signs of velocity returning to more normal patterns, as you might expect, which means, particularly for M_1, a rising pattern of velocity during a period of business expansion. That still has to be a somewhat tentative judgment against abnormalities that we have had in the past couple of years and we still feel somewhat tentative about the judgment about M_1. We tend to evaluate growth in M_1 against wider targets that will have substantial weight in our operations.

As far as the actual targets for 1984 are concerned, they are essentially the same as those we announced in a preliminary way last July. The one difference is one-half of 1 percent further decline in M_2, which is partly influenced by technical considerations. Broadly, they are very similar to those we announced earlier.

In terms of our immediate operations, the amount of reserves being provided, the degree of pressure on bank reserve positions, that posture has been essentially unchanged for some months. It remains unchanged. That reflects a view of the growth in the aggregates being reasonably in line with our intentions. It also reflects the view that the economy has continuing momentum and that price performance has been in line with expectations and satisfactory, certainly looking backward.

In that operational sense, what happens to interest rates as the year wears on is going to be determined in large part by what happens to the economy and the strength of demands or the lack thereof.

We, meaning members of the Open Market Committee and the other presidents of the Reserve banks, have set forth some economic projections which I think fall generally in line with those of the administration and indeed those that the CBO announced yesterday, and in line with the prevailing view of outside economists, and which show the growth at a slower rate of speed than last year. You typically get the most rapid growth immediately coming out of a recession, as we did last year. We still show a very healthy rate of growth in the 4- to 4¾-percent area.

We also assume some increase in the rate of price increase. That would not be unusual during a period of business expansion, during the second year of expansion.

There are some special factors affecting prices, but obviously that is a sensitive area. I think you can get a small rise in the rate of increase next year without being contradictory to a general trend toward price stability, but if that got large and raised a doubt, that basic trend would have an influence on the marketplace and an influence on the prospects for orderly economic development over a period of time.

Price performance last year was as good as could have been expected and perhaps better than most people expected.

When we put together an analysis of 1983 and try to do that in a little longer perspective, I think there are very considerable signs of progress that augur well for the future of the economy. We seem to be having productivity growth again. We have a lot more emphasis on restraining costs. Real incomes have been rising at the same time that nominal wages and salaries have been increasing more slowly. That's the kind of pattern you have to maintain through expansion, and that kind of pattern would have a great deal to do with this expansion being continued for a long period of time and leaving us with good economic performance over the decade as a whole.

There are all sorts of signs that we have a great opportunity to extend the economic progress, but at the same time, as you well know—and you have already alluded to one aspect of it—there are real risks in current imbalances as we move ahead. You can see some of those in the fact that while certain types of investment expanded pretty well in 1983, the investment sector of the economy is relatively low, given the total size of the economy currently. Housing has leveled off at levels below those characteristic of some earlier periods. The amount of net while rising, remains relatively low, and that reflects back on the outlook for capacity and the outlook for productivity over a period of time.

FOREIGN TRADE DEFICIT

In a way, the most striking and disturbing aspect of developments last year was the increase in the foreign trade deficit. I was reading in the paper this morning that that reached the neighborhood of $60 billion last year and there are many projections that the trade deficit will rise to over $100 billion during the current year. The trends are certainly in that direction. While we have a surplus in other items in the current account, the current account picture reflects that pattern, with a deficit of $40 billion last year, and if the trade deficit is over $100 billion, it could be double that, in the neighborhood of $80 billion, this year. That obviously has implications for industry that is concerned with exports and with import competition. That has been a sector of the economy that has not at all shared in the same degree in the rapid recovery we have had.

Looking at that same phenomenon from another direction—from the other side of the same coin—we are becoming increasingly dependent upon importing foreign capital. The projections suggest

that we will import foreign capital net equal to about 2 percent of our GNP or more in 1984. That has its good aspects, in the sense that it is becoming an important element in keeping interest rates where they are in the face of the budget deficit, in the face of the economic recovery. Interest rates have not gone up; they are being moderated by an inflow of foreign capital. But you have to ask yourself how long we can count on increasing amounts of foreign capital to, directly or indirectly, finance our budget deficit.

It takes pressure off some areas of the domestic economy, but it's also reflected in strong pressures on the export sector of the economy and on the import competing sector. It certainly does not give a balanced picture, and it is a source of some considerable concern, because one wonders what the sustainability of that picture is.

I think it gives a picture of risks that become greater as the economy grows and of an enormous stimulus in one direction from the budget deficit. That budget deficit, in turn, as I say, is indirectly or directly being financed abroad, removing some of the pressures on the market, but impairing greatly the external sector of the economy. As soon as the capital inflow stops, all that pressure will come back and have to be financed internally. Then you have to ask yourself, what happens to investment? What happens to housing? What happens to the future of the economy, which otherwise looks to be so promising?

Interest rates certainly remain high relative to the inflation rate. I think it's hard to say, looking backward, they have been too high. We have had a very good recovery and certainly the recovery has succeeded despite that level of interest rates. But looking ahead, these interest rates are too high for the continuing health of the economy, much less can we tolerate an increase. We'd like to see decreases not only to maintain housing but, even more importantly, to provide the environment for the kind of investment we need domestically. That's easy to say. It's a question of how it can be achieved.

Certainly when you look at the alternatives before us in terms of economic policy and raise the question of what to do, it does not seem to me the answer lies in increasing the money supply to rates that would be potentially inflationary and destroy the progress we have made against inflation. It seems to me pretty clear that that policy, whatever its intent, would not be consistent with lower interest rates over time. It would, instead, mean higher interest rates over time, and if people had that suspicion, that we were embarked on a course of reinflation, it would produce higher rather than lower interest rates very quickly.

At the same time, I think it's hard to say right now when there are some signs of a somewhat slower rate of economic growth, a satisfactory rate of economic growth, that there's any point right at the moment to further restriction on the monetary policy side. That all depends on how the total outlook develops as the year progresses.

PROTECTIONISM IN THE FOREIGN TRADE SITUATION

When one looks at the foreign trade situation, a quick reaction may be that's an excuse for protectionism. I don't think that that's

going to help anything. It will only harm things over time. It would be an inflationary factor. It might shift the pain to some degree in the short run, from one industry to another, but it doesn't deal with the basic problem of our dependence upon an inflow of foreign capital. And so long as that is true, so long as the exchange rate implications of that are such as to damage our foreign trade position, I think there's no answer, except a damaging one, from the protectionist solution.

I think also, as you already suggested, Mr. Chairman, that there is one obvious constructive change that could be made in our mix of policies and our general approach toward economic policy, and that would be to move more aggressively to reduce the budgetary deficits that put pressure on our internal markets and that contribute directly and indirectly to our dependence upon the foreign inflow of capital and that have undermined our international trade position. That is not a startling conclusion, and I know it is a lot easier to state that conclusion than to arrive at the political compromises and arrangements that are necessary to actually implement that kind of conclusion. But I can only urge upon you that time is passing; that the risks seem to me to increase. Those risks, ironically, get greater the better the economy does in an overall sense. The more rapidly the economy moves forward, the greater demands will be placed upon our credit markets from other sources and the more urgent it becomes to deal with the deficit.

We have made a lot of progress, but the time is here—maybe in some sense it's passed—to begin dealing with this. Certainly looking ahead, I think that the risks and hazards become progressively greater. It certainly is time to act, and I can only hope that through the vehicle of the task force that the President proposed, or otherwise, that prompt action can be taken to make significant inroads on the budgetary problem.

Mr. Chairman, I am prepared to answer your questions.

[The complete statement and report follow:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to be meeting with this Committee once again to discuss the Federal Reserve's monetary policy objectives for the year ahead. You have before you the official monetary policy report that is required under the Humphrey Hawkins Act. That report, which was released Monday, describes rather fully the current economic situation and sets out our decisions with respect to monetary policy in detail. My prepared remarks this morning will focus mainly on some broader considerations that seem to me to bear crucially on our approach to monetary policy, on the interaction of monetary policy with other policies, and on our economic prospects.

Monetary Policy "Targets" for 1984 and Economic Projections

At its meeting last week, the Federal Open Market Committee essentially reaffirmed the ranges for money and credit growth tentatively established in July of last year. Those new target ranges are set out in Table I attached, against the background of last year's targets.

As there indicated, the target ranges for M3 and for nonfinancial debt were lowered by 1/2 percent from the 1983 ranges to 6-9 and 8-11 percent, respectively, as tentatively set in July. The M2 range was reduced by 1 percent from the 1983 range to 6-9 percent. That is 1/2 percent lower than anticipated in July, reflecting in part technical considerations bearing on the appropriate relationships among the broader aggregates. The M1 range was set at 4-8 percent, 1 percent lower than during the second half of 1983, as had been anticipated.

These targeted ranges envisage that the relationships between the monetary aggregates and the nominal GNP -- that is, "velocity" -- will return to patterns much closer to historical norms than was characteristic of 1982 and early 1983. Developments as 1983 progressed pointed in that direction. At year-end, all the targeted aggregates appeared to be within the 1983 ranges;* a tendency for velocity to rise -- in contrast to historically large declines in 1982 and early 1983 -- was more in line with past cyclical experience. Further experience will be necessary to confirm the validity of that judgment, and the Committee recognizes that recent regulatory and institutional changes may be reflected in some changes in the underlying trends of velocity, particularly for M1.

For that reason, substantial weight will continue to be placed on the broader aggregates for the time being, and growth in M1 will be evaluated in the light of the performance of the other aggregates. All the aggregates will be interpreted against the background of developments in the economy, current and prospective price pressures, and conditions in domestic credit and international markets.

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*Subsequent benchmark revisions increased growth of all the monetary aggregates fractionally, bringing M3 slightly above the targeted range during the fourth quarter. The revised data are reflected in Table II and the charts attached.

More detail about the new targets and 1983 performance is provided in the Humphrey Hawkins Report itself, and I will be glad to address any questions you have about them.

In setting the new target ranges, the Committee members generally felt that economic activity would continue rising through 1984 and into 1985 at a more moderate -- and potentially more sustainable -- pace of 4 to 4-3/4 percent. That growth is expected to be accompanied by some further decline in the unemployment rate to the area of 7-1/2 to 7-3/4 percent. Cyclical factors and special circumstances -- including the effects of bad weather -- are expected to be reflected in a little larger price increase on average, following the remarkably good progress of 1982 and 1983.

Taken together, those projections resemble those set out by the Administration and many others, and they suggest a generally satisfactory economic performance is probable in 1984. But those summary forecasts should not divert our attention from certain serious problems that have emerged. As I assess the outlook, there are clear hazards and risks before us. Unless dealt with forcefully and effectively, they will jeopardize the good prospects for 1984 and beyond.

The Opportunity and the Risks

A year ago, in appearing before you on this occasion, I emphasized that, after too many years of pain and instability, we had an enormous opportunity to sustain growth for years ahead in an environment of much greater price stability. Today, after a year of strong recovery, that sense of the opportunities before us has only been reinforced.

The simple fact is that the economy moved ahead faster, and unemployment dropped more sharply, than we or most others thought at all probable. At the same time, the inflation rate dropped further, to the point that producer prices were almost unchanged over the year as a whole and consumer prices rose by less than at any time over the past decade. The fact that we were able to combine strong growth with good price performance is what is so encouraging. It is the key to lasting success.

With job opportunities, real incomes, and profits all rising, so has the sense of optimism among both families and businesses. That widely shared impression is confirmed statistically in the results of "attitudinal" indices that attempt to measure confidence, expectations, and buying plans -- they are mostly at the highest, or near the highest, levels in many years.

I realize that improvement must be measured from where we started. There was a lot of room to grow, and the early stages of recovery typically see rapid growth and less price pressures. Any satisfaction with what has been happening has to be tempered by the knowledge there is still a considerable way to go to reach satisfactory levels of employment and before we can claim to have restored reasonable price stability. In particular, should inflationary trends and fears again take hold, prospects for the lower interest rates and orderly credit markets we need to support investment and productivity growth would be shattered.

I hardly need to remind you that inflation has tended to worsen during periods of cyclical expansion. But that need not be inevitable. Out of hard experience, I believe we can shape disciplined policies -- indeed, we have already gone a long way toward shaping policies and attitudes -- toward dealing with the threat.

What we have not done in this past year is face up to other hazards to our prosperity and to our stability -- hazards that are new to our actual experience but which have been long identified. I am referring, of course, to our twin deficits: the structural deficit in our Federal budget and the deficit in our external accounts -- both at unprecedented levels and getting worse. Both of those deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act -- but in my judgment, not much time.

Sources of Strength

I can summarize briefly why I think the developments of the past year are, in key respects, so promising -- why, potentially, what has been going on can be not "just another" cyclical recovery, but the start of a long process of growth and renewed stability.

Looking back, it is now apparent that the trend of productivity growth had practically stopped in the late 1970's. But productivity began to increase again during the recession and rose rapidly during most of last year. One or two years do not make a new trend, and relatively good productivity growth is typical of the early stages of recovery. But the evidence -- quantitative and qualitative -- suggests something more than cyclical forces are at work in important areas of the economy. Under the pressure of adversity -- and with the seemingly "easy pickings" of speculative and inflationary gains

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diminishing -- management and labor alike have turned their efforts and their imagination toward ways to increase efficiency and to curtail overhead.

That, together with growing markets, accounted for the speed of the rebound in total profits and improvement in profit margins last year from long-depressed levels, even as prices for many goods and services tended to stabilize. The cash flow of businesses has been further reinforced by the liberal treatment of depreciation and other tax changes enacted in recent years, and after-tax economic profits, only a year after recession, are approaching the highest levels of the 1970's relative to GNP. Strong expansion in some types of investment during 1983 -- particularly electronic equipment where technological change has been so rapid -- carries promise for future productivity.

We should not claim too much. Profits remain well below rates typical of the prosperous 1960's. Recent employment increases, while highly welcome in themselves, have been so large relative to output growth that they raise some questions about whether rapid productivity growth is being maintained. Long-lived investment -- new plant for expansion of capacity -- still lags. High interest rates, the uncertainty bred by years of disappointment, and strong competition from abroad all have restrained

heavy investment. Already, a few industries are close to, or even at, sustainable capacity. But, on balance, the evidence and the omens are more favorable than for several years.

That is certainly true of the longer-term outlook for costs and prices. I am well aware that slack markets and excessive unemployment, the appreciating dollar together with the ready availability of goods from abroad, and the decline in world oil prices all helped account for the rapidity of the drop in the general inflation rate and the degree to which cost pressures have subsided. To that extent, progress toward stability has had a sizable "one time," or cyclical, component. But we also now have a clear opportunity to "build-in" that improvement -- the best opportunity in many years.

As the increase in average wages and salaries, which account for some two-thirds of all costs, has declined in nominal terms, the real income of the average worker has increased. That reverses the pattern as inflation accelerated during much of the 1970's when escalating wages often lagged behind more rapidly rising prices. The more favorable pattern should be assisted by greater stability in energy prices, where the outlook (barring political turmoil) appears favorable, and by stronger productivity growth. With real wages again rising on average, and with prices more stable, the logic points toward much more moderate new wage contracts than became the norm in the inflationary 1970's. The competitive

pressures associated with the process of deregulation in some important industries also have been a factor working to contain costs and prices, and happily we can begin to see some signs of more restrained cost increases in areas, such as medical care and education, that have been slow to reflect the disinflationary process.

To the extent we can build confidence in the outlook for more stable prices, the process could, potentially, feed on itself. Incentives for speculation in commodities, and for speculative excesses, would be greatly reduced and possibilities of another burst in oil prices diminished. It could provide the best possible environment for declines in interest rates over time -- nominal and real -- and interest rates are themselves an element of costs. Lower interest rates could, in turn, be a powerful factor supporting and encouraging housing and the business investment that we need to maintain economic momentum and to support productivity growth.

The Problems

Nonetheless, as I suggested a few minutes ago, the prospects for sustained growth and stability must remain conditional. There is another, and bleaker, reality. We are faced with two deficits -- in our budget and in our international accounts -- unprecedented in magnitude. Those twin deficits have multiple causes, but they are

not unrelated. Left untended, each, rather than improving, will tend to cumulate on itself, until finally they will undercut all that has been achieved with so much effort and so much pain.

Looking back, the rising budget deficit provided a large and growing stimulus to purchasing power as we emerged from recession. It helped account for the vigor of consumption in the face of historically high interest rates. The other side of the coin is that financing the deficit last year amounted to three quarters of our net new domestic savings. That was tolerable -- we obviously have tolerated it -- for a limited period of time when other demands on those savings were limited. Business inventories actually declined on balance last year, and housing and business investment were recovering from recession lows.

Even then, deficits were a factor keeping interest rates higher than otherwise, and the implications become much more serious as the economy grows closer to its potential. The hard fact is that for many years we have succeeded in saving (net of depreciation) only some 7 to 9 percent of our GNP. Despite the efforts to raise it, the domestic savings rate remains within that range now and foreseeably. If the budgetary deficit absorbs amounts equal to 5 percent or more of the GNP as the economy grows -- and that is the present prospect for the "current

services" or "base line" budget -- not much of our domestic savings will be left over for the investment we need.

Over the past year, our needs have been increasingly met by savings from abroad in the form of a net capital inflow. That money has come easily; amid world economic and political uncertainty, the United States has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets. At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of a growing trade and current account deficit -- and the dollar appreciation in turn undercut our world-wide trading position further.

We simply can't have it both ways -- on the one hand, look abroad for increasing help in financing the credits related to our budget deficit, our housing, and our investment, and on the other hand, expect to narrow the growing gap in our trade accounts. At the end of the day, the counterpart of a net capital inflow is a net deficit on our current account -- trade and services -- with other countries.

Most forecasts suggest that we, as a nation, will have to borrow abroad (net) about 2 percent or more of our GNP this year to meet projected domestic needs. That pace does not appear sustainable over a long period. Faced at some point with a reduction in the net flow of capital from abroad, the burden of financing the budget deficit would then be thrown back more fully on domestic sources of savings. If our Federal financing needs remain so high, housing and investment will be squeezed harder.

I must also point out that, in the same way that the interest costs of this year's deficit add to next year's requirements -- and compound over many years thereafter -- the interest and dividend payments related to the net capital inflow builds up future charges against the current account of the balance of payments. Skepticism about our ability to account accurately and fully for all the flows of funds into or out of the country is justified; it is nonetheless ominous that the recorded net investment position of the United States overseas, built up gradually over the entire postwar period, will in the space of only three years -- 1983, 1984, and 1985 -- be reversed. If the data at all reflect reality, the largest and richest

economy in the world is on the verge of becoming a net debtor internationally, and would soon become the largest.

Looking at the same development from another angle, it is the exporter, and those competing directly with imports, that have not shared at all proportionately in the recovery. Developments in the fourth quarter illustrate the point. There has been much comment about the slowing in the rate of GNP growth to a rate of about 4-1/2 percent. But, judging from the preliminary figures, domestic demands were quite well maintained, increasing at a rate of almost 7 percent. Much of that increased demand flowed abroad, adding to income and production elsewhere. It was domestic production, not demand, that grew appreciably more slowly.

For a time, as with the budget deficit, that kind of discrepancy is tolerable. Indeed, from one point of view, it has provided a welcome impetus toward stimulating the growth process in other countries of the industrialized world, and the strength of our markets assisted the external adjustments necessary in the developing world. We can also take pride in the fact that others find the United States an attractive place to invest; good performance and policies can help sustain those flows.

But we simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help

finance our internal economy. Part of our domestic industry -- that part dependent on exports or competing with imports -- would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

The Implications for Monetary Policy

In the abstract, the ultimate objective of monetary policy is simple to state and widely agreed: to provide just enough money to finance sustainable growth -- and not so much as to feed inflation. In the concrete, issues abound.

Some of them are more or less technical -- how we define and measure money and its relationship to the nominal GNP. These questions are dealt with in our formal report describing our decisions on the targets. I want here to concentrate on some broader implications of the current situation for the conduct of monetary policy.

There is no instrument of monetary policy that, in any direct or immediate sense, can earmark money only for expansion and not for inflation, or vice versa. The distribution of any given nominal growth of the GNP between real growth and inflation is a product of many

factors -- the flexibility and competitiveness of product and labor markets, the exchange rate, and internal or external shocks (such as the oil crises of the 1970's). Expectations and attitudes developed out of past experience are critically important.

In that respect we have not inherited a sense of stability. Quite to the contrary, the legacy of the 1970's was deeply ingrained patterns of behavior -- in pricing, in wage bargaining, in interest rates, and in financial practices generally -- built on the assumption of continuing, and accelerating, inflation. Starving an inflation of the money needed to sustain it is a difficult process in the best of circumstances; it was doubly so when the continuing inflationary momentum was so strong.

Now, after a great deal of pain and dislocation, attitudes have changed -- there is a sense of greater restraint in pricing and wage behavior, a greater recognition of the need to improve efficiency, less alarm (at least for the short run) over the outlook for prices, and relative confidence by others in the outlook for the United States. In this setting, we can assume that, within limits, more of any given growth in the money supply will finance real activity and less rising prices than would have been the case when the inflationary momentum was high.

But we also recognize that the battle against inflation has not yet been won -- that skepticism about our ability, as a nation, to maintain progress toward stability is still evident. That is one of the reasons why longer-term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the skepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter -- that the Federal Reserve is not prepared to accommodate a new inflationary surge as the economy grows. The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy-nilly, push us in that direction, as has happened in so many countries.

The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth would soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would in the end be perverse -- and likely sooner rather than later. As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive

investment. Inflationary policies would also discourage the continuing flow of funds from abroad, upon which, for the time being, we are dependent. In the last analysis, willingness to provide those funds freely at current or lower interest rates is dependent on confidence in our stability and in our economic management. Depreciation of the dollar externally as a result of inflationary policies will not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, the greatest contribution that the Federal Reserve itself can make to our lasting prosperity is to foster the expectation -- and the reality -- that we can sustain the hard-won gains against inflation and build upon them.

In my judgment, against a background of more stable prices, interest rates are indeed too high for the long-term health of the United States or the world economy. I have repeatedly expressed the view that, as we maintain the progress against inflation, interest rates should decline -- and they should stay lower.

Much is at stake. We will need more industrial capacity, and relatively soon. Even after the sharp declines in interest rates from earlier peaks, many thrift institutions and businesses remain in marginal profit positions and with weakened financial structures; lower

rates would bring much faster progress in repairing the damage. The cooperative efforts of borrowers, banks, and the governments and central banks of the industrialized world have managed to contain the strains on the international financial system, but the pressures are still strongly evident. Both economic growth and lower interest rates are needed as part of more fundamental solutions.

But wish and desire are not the same thing as reality -- we have to deal with the situation as it is. In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the FOMC had to remain alert to the danger of renewed inflation as well as to the need for growth. It also decided that, operationally, it would for the time being be appropriate to maintain essentially the same degree of restraint on the reserve positions of depository institutions that has prevailed since last autumn.* That judgment reflects the fact that growth in the various measures of money and credit now appears broadly consistent with objectives, that the momentum of economic expansion remains strong, and inflationary tendencies contained. That operational judgment will, of course, be reviewed constantly in the weeks and months ahead.

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*In the very short run, account will be taken of possible increases in the level of excess reserves occasioned by the transition to contemporaneous reserve accounting.

Those decisions will reflect continuing appraisals of the rate of growth of money and credit, interpreted in the light of all the evidence about economic activity, prices, domestic and international financial markets, and other relevant considerations. All those factors will, in turn, be affected by other public and private policies. In that context, it is the strength of economic activity, the demand pressures on the credit markets, and the willingness of others to invest in the United States that will influence the course of interest rates.

In approaching our own operational decisions, the actual and prospective size of the budget deficit inevitably complicates the environment within which we work. By feeding consumer purchasing power, by heightening skepticism about our ability to control the money supply and contain inflation, by claiming a disproportionate share of available funds, and by increasing our dependence on foreign capital, monetary policy must carry more of the burden of maintaining stability and its flexibility, to some degree, is constrained.

Toward a Positive Solution

Monetary policy is only one part of an economic program. It is an essential part, but success is dependent on a coherent whole.

I have tried to demonstrate that we have come a long way -- that we have much upon which to build sustained prosperity.

Many of the portents are favorable.

Public policy has encouraged greater competition, removed harmful regulatory restraints, and provided greater incentives. There are hopeful signs that productivity is again growing, and a healthy concern about costs and efficiency. Energy prices have stabilized. We have had a strong recovery, and the progress toward price stability has been gratifying.

Prospects for extending that success rest in part on continuing discipline by business and labor. We cannot afford to return to the syndrome of the 1970's, with prices and wages chasing each other amid fears of inflation, amid erosion of productivity and real incomes. The experiments in the private sector with profit sharing, with quality circles, and with other forms of labor-management cooperation -- efforts born in adversity -- can bear fruit in prosperity.

If they are to do so -- if a sense of discipline is to be maintained -- those of us responsible for public policy must be able to demonstrate that inflation will not again get the upper hand -- that productivity and restraint will be rewarded, not penalized in favor of those seeking inflationary or speculative gain.

The contribution that monetary and other policies make to that environment is critical. As the expansion proceeds, and as some of the temporary factors restraining prices recede, we as a nation simply cannot afford to permit inflation to attain a new momentum. Our monetary policies are, and in my judgment must continue to be, geared to avoid that danger.

But for all that progress and promise, something is out of kilter.

Our common sense tells us that enormous and potentially rising budget deficits, and the high and rising deficits in our trade accounts, are wrong -- they can not be indefinitely prolonged.

That common sense is confirmed by simple observation. Some of our proudest industries -- potentially capable of competing strongly in world markets -- are in trouble, tempted to shift more operations abroad for sheer survival or demand protectionist walls. Interest rates remain historically high, threatening housing and investment.

And, in this instance, economic analysis bears out, and amplifies, the judgments of common sense and simple observation. Our two deficits are related. The budget deficit, by outrunning our ability to save, damages prospects for housing and for investment, and makes us dependent on foreign capital. That capital from abroad, for the present, alleviates the pressure on our money

markets, but it complicates our trade position. And if and as our trade account improves, the brunt of financing excessive budget deficits would fall back more fully on domestic savings, squeezing domestic capital spending harder.

We can, of course, sit back and wait awhile longer, hoping for the best.

I certainly have some understanding of the difficulties of achieving a consensus on difficult budgetary choices when a sense of immediate crisis is lacking -- when for the moment things seem to be going so well.

But I also know to wait too long would be to take risks with the American economy.

It is already late. The stakes are large. Markets have a mind of their own; they have never waited on the convenience of kings or Congressmen -- or elections.

The time to take the initiative is now, when we can influence markets constructively -- when we can demonstrate that we are in control of our own financial destiny. Real progress toward reducing the budget deficit is needed to clear away the dangers.

I sense a fresh opportunity in the proposals of the President for a joint effort to attack the deficit -- for a sizable "down payment" on what is ultimately needed.

Certainly, that kind of demonstration that we are beginning to face up to our budgetary problem would make it easier for monetary policy to do its necessary work. And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.

31-490 O—84——3

Table I

Federal Reserve
Objectives for Money and Credit Growth in 1984[1]

	New ranges for 1984 (%)	Tentative ranges for 1984 set in July 1983 (%)	Ranges for 1983 established in July 1983 (%)
M2	6 to 9	6-1/2 to 9-1/2	7 to 10[2]
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9[3]
Domestic Nonfincial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983.
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Table II

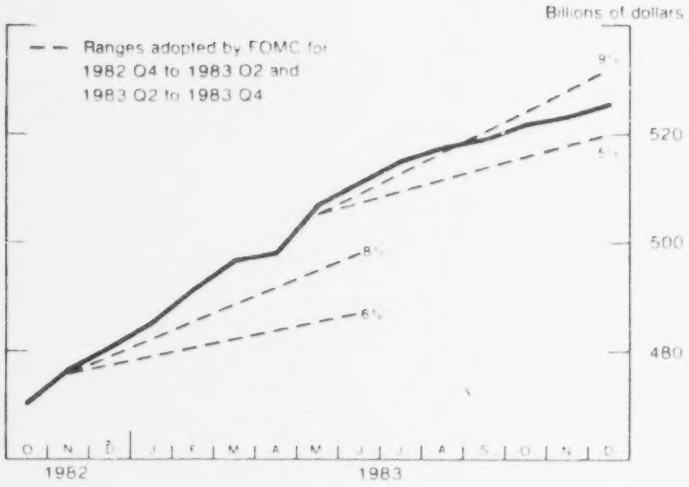
Federal Reserve Objectives for Money and Credit in 1983
and Actual Growth

	Ranges for 1983 established in July 1983 (%)	Actual growth (%)	
		Revised data	Old data
M2	7 to 10[1]	8.3	7.8
M3	6-1/2 to 9-1/2[2]	9.7	9.2
M1	5 to 9[3]	7.2	5.5
Domestic Nonfinancial Sector Debt	8-1/2 to 11-1/2	10.5	10.5

1. Range applies to period from February-March 1983 to fourth quarter of 1983.
2. Range applies to period from fourth quarter of 1982 to fourth quarter of 1983.
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

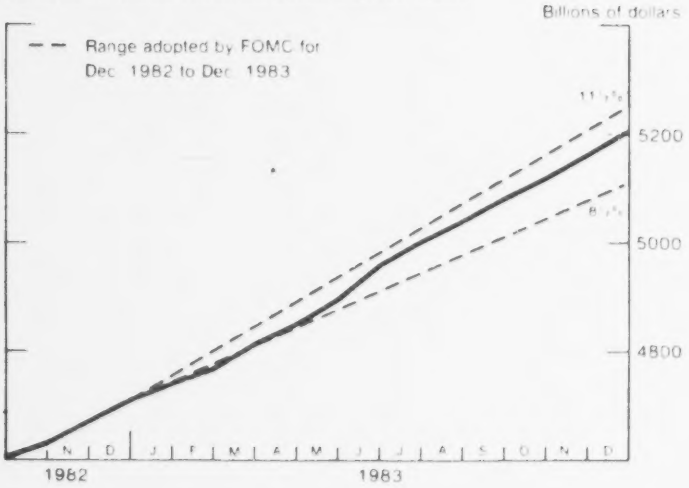
Chart 1 Ranges and Actual Money and Credit Growth

M1



Rates of Growth (annual rate)
1982 Q4 to 1983 Q2
12.4 percent
1983 Q2 to 1983 Q4
7.2 percent

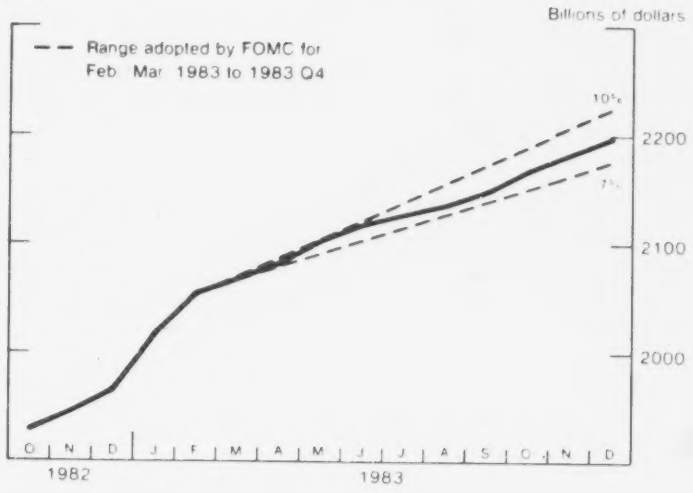
Total Domestic Nonfinancial Sector Debt



Rate of Growth
Dec. 1982 to Dec. 1983
10.5 percent

Chart 2 Ranges and Actual Money Growth

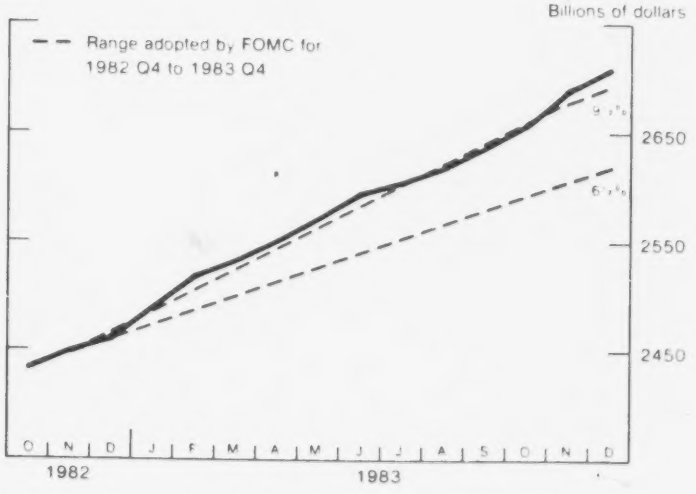
M2



Rate of Growth
(annual rate)

Feb. Mar. to 1983 Q4
8.3 percent

M3



Rate of Growth

1982 Q4 to 1983 Q4
9.7 percent

FOR USE AT 9:15 A.M., E.S.T.,
MONDAY
FEBRUARY 6, 1984

Board of Governors of the Federal Reserve System

Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

February 7, 1984

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 7, 1984

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

Summary of Federal Reserve Monetary and Credit Growth Objectives and Economic Projections for 1984

Objectives for Money and Credit Growth[1]

	New ranges for 1984 (%)	Tentative ranges for 1984 set in July 1983 (%)	Ranges for 1983 established in July 1983 (%)
M2	6 to 9	6-1/2 to 9-1/2	7 to 10[2]
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9[3]
Domestic Nonfinancial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Economic Projections for 1984

	FOMC members and other FRB Presidents		Administration
	Range	Central tendency	
Change, fourth quarter to fourth quarter (%)			
Nominal GNP	8 to 10-1/2	9 to 10	9.8
Real GNP	3-1/2 to 5	4 to 4-3/4	4.5
GNP deflator	4 to 6	4-1/2 to 5	5.0
Average unemployment rate in the fourth quarter (%)	7-1/4 to 8	7-1/2 to 7-3/4	7.7

Federal Reserve Objectives for Money and Credit in 1983
and Actual Growth

	Ranges for 1983 established in July 1983 (%)	Actual growth (%)	
		Revised data	Old data
M2	7 to 10[1]	8.3	7.8
M3	6-1/2 to 9-1/2[2]	9.7	9.2
M1	5 to 9[3]	7.2	5.5
Domestic Nonfinancial Sector Debt	8-1/2 to 11-1/2	10.5	10.5

1. Range applies to period from February-March 1983 to fourth quarter of 1983.
2. Range applies to period from fourth quarter of 1982 to fourth quarter of 1983.
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Section 1: The Outlook for the Economy in 1984

Conditions in the national economy took a decided turn for the better in 1983. Real gross national product rose 6 percent over the four quarters of the year, close to the experience during the first years of past cyclical recoveries but well above earlier projections. Although unemployment remained painfully high, rising production spurred gains in employment large enough to cut the unemployment rate by 2-1/2 percentage points over the course of the year. At the same time, most broad measures of prices and wages recorded further progress toward lower inflation. In short, the performance of the economy in 1983 suggested that the immediate objective of permitting sufficient growth in monetary and credit aggregates to foster a solid economic recovery, while not encouraging developments that would rekindle inflationary pressures, was achieved.

But success cannot be measured by performance during any one year, and in some respects the first year of recovery--beginning in the context of excess capacity and high unemployment--provided the most favorable environment for combining economic growth with progress toward price stability. The more stringent and meaningful test will come as we seek to maintain the momentum of expansion and the progress toward stability while the margin of unemployed resources diminishes. Moreover, developments in 1983 were marred by certain structural imbalances, particularly in the federal budget and in foreign trade, that represent risks to orderly progress.

At present, the prospects for extending the economic gains of the past year into 1984 appear, by and large, to be good. Economic growth slowed in the final quarter of 1983, with real GNP up 4-1/2 percent at an annual rate. A continuation of growth in that general range would be consistent with

significant progress toward lower unemployment this year and with sustained expansion in a framework of greater price stability in the years beyond.

As is typical, the composition of output is likely to change as the cyclical expansion moves through its second year. Business investment in plant and equipment can be expected to provide a greater share of the impetus to economic growth, reflecting continuing gains in sales, rising capacity utilization, and improved profitability. Conversely, 1984 probably will see smaller contributions to growth from those sectors that lent early strength to the recovery. Housing activity surged early in 1983, largely in reaction to the sizable decline in mortgage rates that started in mid-1982; absent an appreciable movement in mortgage rates from current levels, homebuilding can be expected to be more stable this year. Consumption spending, whose upswing strongly boosted aggregate demand in 1983, is likely to decelerate in the coming year: for the first time in several years, spendable income will not be enhanced by a major federal tax cut, and any considerable further decline in the saving rate appears improbable. Inventory behavior is always uncertain; however, with the liquidation and initial-accumulation phases of the cycle complete, inventory investment in 1984 is likely to add less to economic growth than in 1983. Stocks will probably remain low relative to sales, since high financing costs and new methods of inventory control are a restraining influence.

The prospects for continued progress against inflation have been improved by better productivity performance, more realistic wage bargaining, and a more competitive environment for price decisions. The supply-demand situation in the oil market suggests that another inflationary shock from that source is unlikely, and indicators of inflation expectations have remained at

lower levels thus far in the recovery. These factors all provide favorable portents for the future, but they will be tested as economic expansion continues. The firmer labor and product markets that are normally associated with the second year of an economic recovery could cause some cyclically sensitive prices to rise; a social security tax increase for employers will boost labor costs; food prices are likely to be higher than they otherwise might because of the effects of last summer's drought on meat prices.

While these latter forces need not in and of themselves mean the underlying trend toward lower rates of inflation has ended, they could, if associated with other factors, tend to increase inflation expectations and generate broader pressures on prices and wages. One of the possibilities is that the competitive forces associated with the appreciation of the dollar and the ample availability of goods from abroad--which have been exerting downward pressures on the rate of inflation--could recede. More fundamentally, as margins of excess capacity diminish--to the vanishing point in a few industries--and as the availability of experienced labor declines, there may be temptations to revert to the pricing and wage bargaining patterns characteristic of earlier years of rapid inflation.

Furthermore, as time passes, the imbalances associated with the current expansion will pose increasing risks. The second year of an expansion of economic activity is likely to bring with it growing business credit demands. At the same time, unless decisive action is taken, the federal government deficit will continue to drain off an extremely large portion of available net saving in the economy. With no easing of the tensions in credit markets, interest-sensitive sectors, such as housing and long-term business investment, in all probability will continue to operate well below their underlying potential

and below the levels consistent with sustained, balanced economic growth and a strong productivity performance.

The large federal government deficit has had repercussions for the international economy as well. By adding to pressures on domestic credit markets, it has helped induce an inflow of capital from abroad, exerting upward pressure on the dollar, even as our trade and current account balances have deteriorated. Further deterioration in the external balance is expected this year, and that trend and level of imbalance cannot be sustained indefinitely. Under these circumstances, it certainly is questionable whether we can count on the continuing eagerness of foreigners to invest in increasing amounts of dollar-denominated assets, and this has significant implications for potential developments in credit and exchange markets. Even if the recent trends in the trade balance could be sustained, it is not at all clear that the consequences for American industry would be acceptable.

Moreover, the federal deficit and associated high U.S. interest rates will continue to aggravate the debt servicing problems of major international debtors. To be sure, the approval of funding for the International Monetary Fund, the support of official creditors, and the widespread cooperation of the private banking community have been constructive. But, while key developing countries have put in place economic adjustment policies that have resulted in necessary reductions in their imports, such progress has been achieved at high cost to their domestic economies. Thus, countries with heavy debt burdens still confront the task of restoring growth of real income as structural adjustments proceed. An important contribution to this effort, as well as to our own long-run economic health, is the continued access of these nations to the financial and goods markets of industrial countries.

The Economic Projections of the FOMC

While recognizing the risks implicit in the budgetary and international circumstances outlined above, the members of the Federal Open Market Committee (together with other Reserve Bank presidents) believe the most probable course of developments during 1984 is further growth, significant reduction in unemployment, and only modest--and essentially cyclical--increases in price pressures. The central tendency of forecasts shows real GNP growth in a range of 4 to 4-3/4 percent this year. This growth rate is similar to the

ECONOMIC PROJECTIONS FOR 1984
(Percent)

Economic indicator	FOMC members and other FRB Presidents		Administration
	Range	Central tendency	
Change, fourth quarter to fourth quarter			
Nominal GNP	8 to 10-1/2	9 to 10	9.8
Real GNP	3-1/2 to 5	4 to 4-3/4	4.5
GNP deflator	4 to 6	4-1/2 to 5	5.0
Average unemployment rate in the fourth quarter	7-1/4 to 8	7-1/2 to 7-3/4	7.7

first view expressed by the members last summer, but, of course, would follow significantly faster growth in 1983 than anticipated. The unemployment rate is expected to continue to decline in 1984, and given the progress in reducing joblessness last year, the expected level of unemployment in the fourth quarter of this year--generally between 7-1/2 and 7-3/4 percent--is substantially lower than had been anticipated.

FOMC members expect the GNP implicit deflator to rise a bit more rapidly this year than in 1983--generally in the range of 4-1/2 to 5 percent. While some members have expressed concern that recent labor force trends and pressures on capacity in a few industries could lead to a more significant pickup in inflation, such a development generally is perceived to be only a risk rather than the most likely outcome.

Section 2: The Federal Reserve's Objectives for the Growth of Money and Credit

At its meeting of January 30-31, the FOMC modified only slightly the tentative ranges for the monetary and credit aggregates for 1984 established last July. The ranges for M2 and M3 were set at 6 to 9 percent, 1 percent and 1/2 percent, respectively, below the ranges for 1983. The tentative M1 growth range of 4 to 8 percent was confirmed for the same period. A monitoring range of 8 to 11 percent, as anticipated in July, was established for growth in the outstanding debt of domestic nonfinancial sectors.

The ranges for 1984 are intended to be consistent with the basic policy objective of achieving long lasting economic expansion in a context of continuing control of inflationary pressures. They assume that relationships between monetary and credit growth and economic activity and inflation will be broadly consistent with past trends and cyclical developments. There is reason to expect that the special considerations affecting monetary growth rates last year--including important institutional changes in the financial system--will be less significant in 1984. Specifically, the large-scale shifts of funds associated with the introduction of money market deposit accounts (MMDAs) and Super NOW accounts appear, for all practical purposes, to be completed. Some of the other influences that had special effects particularly on the demand for M1 last year--uncertainties about the economic and financial outlook early in the year and the lagged effect of the sharp decline of interest rates in late 1982--are behind us. No further regulatory or statutory changes that would significantly affect growth rates of the monetary aggregates appear imminent. Some proposals--such as payment of interest on demand deposits or on required reserve balances--would have

important impacts on the aggregates and would require reconsideration of the ranges, especially for M1, if they were enacted to be effective in 1984.

A 1/2 percent further reduction in the growth range for M2 for 1984 from that tentatively set in last July was influenced by technical considerations. Last year's range--though it was based on February-March to abstract from the bulk of distortions connected with the introduction of MMDAs--necessarily had allowed for some residual shifting into such accounts as the year progressed, which in fact took place. In any event, M2 in 1983 was maintained well within its target range, and growth in 1984 should not be influenced by that special factor.

The Committee anticipates that both M2 and M3, which will continue to receive substantial weight in policy implementation, may well fluctuate in the upper part of their ranges in the current year. The actual growth of M2 and M3 will depend in part on the strategies and aggressiveness with which depository institutions seek deposits in a deregulated deposit interest rate environment.

Growth of the broader aggregates will also be influenced by the pattern of net capital inflows from abroad. For example, nonresident holdings of Eurodollars are not included in M2 or M3, and should banks bid aggressively for funds through that channel, as seems possible, growth in those aggregates would be tend to be restrained relative to growth in bank credit and nominal GNP. Limited allowance was made for that development in setting the ranges.

As tentatively agreed in July, the range for M1 was reduced by 1 percentage point from the range set for the last half of 1983. Growth around the midpoint of the range would appear appropriate on the assumption of relatively

normal velocity growth; if velocity growth remained weak compared with historical experience, M1 growth might appropriately be higher in the range.

In recent quarters, the velocity of M1 has shown a moderate rising tendency, in contrast to sharp declines in 1982 and early 1983. Still, the rise in M1 velocity in the first year of the current economic recovery was decidedly less than in earlier post-World War II cyclical expansions. Velocity behavior over the past 18 months appears to have reflected responses to the declines of interest rates in the latter part of 1982, the subsequent leveling off of rates, changing precautionary attitudes, and to some degree, perhaps, more lasting changes in motives for holding M1 as the composition of the aggregate has shifted.

Since their introduction on a nationwide basis, interest-bearing accounts with full checking privileges (NOW accounts) have become an increasingly important element in M1. Most of these accounts are subject to a ceiling rate, though a growing proportion (Super NOWs) pay market rates. All of the accounts contain funds placed for long-term savings purposes as well as funds used primarily for transactions. In light of these structural changes, it is not yet clear how the public's demand for M1 might be affected, for any given level of income, by variations in credit market or other conditions that affected savings preferences, or how it might be affected by variations in the level of income itself; nor is it clear how quickly or in what ways depository institutions might themselves respond to such variations by altering terms on deposit offerings.

While there is evidence of more "normal" and predictable patterns reappearing, the Committee felt that more time would be required for assessing the impact of recent structural changes on public and institutional behavior

before full or primary weight could be placed on M1 as a policy guide. Thus, the Committee decided, in setting a range for M1, that its behavior should be evaluated in the context of movements in the broader monetary aggregates, which for the time being would continue to be given substantial weight in policy implementation.

The FOMC also considered whether the procedures of System open market operations should be altered in light of the shift to the new contemporaneous reserve requirement system (CRR) on February 2, a system that potentially would permit somewhat closer short-run control of M1. It was the Committee's view that adaptation of open market procedures does not depend on the technical characteristics of the reserve requirement system in place but rather on broader policy judgments about the relative weight to be given to M1 as a target and the desirability of seeking close short-run control of that aggregate. Taking account of policy judgments about the role of M1 and other monetary aggregates under current circumstances, as well as uncertainties in the period of transition to CRR, the Committee agreed to make no substantial change in current operating procedures at this time.[1]

The Committee set a monitoring range of 8 to 11 percent for growth in the debt of domestic nonfinancial sectors during 1984. This range is 1/2 percentage point below the corresponding range for 1983, reflecting the moderating trend that, based on historical relationships, would be expected to accompany progress toward price stability and sustainable growth in production. The range allows for growth of debt in 1984 that might outpace expansion in nominal GNP, as often occurs in the second year of a cyclical recovery.

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1. A statement issued on January 13 on the policy implications of CRR appears as appendix A to this report.

Implications for Credit Markets

Developments in credit markets and interest rates, as always, will be subject to a variety of influences at home and abroad. The ranges specified for the monetary and credit aggregates, which are felt to be broadly consistent with the expectations of members of the FOMC about the course of economic activity and prices, will not in and by themselves determine the course of interest rates and the degree of credit market pressures. Whether interest rates fall or rise--or remain stable--will depend importantly on the strength and composition of demands on the economy, actual and anticipated price pressures, and credit demands.

Dominating the outlook for credit flows in the year ahead is the prospect that--in the absence of immediate action by the fiscal authorities--the federal deficit will approach the record level of the past year. The federal deficit was nearly 6 percent of GNP in 1983, the high for the post-World War II years, and is likely to be only slightly lower in 1984, the second year of cyclical expansion. In the comparable stage of earlier cyclical recoveries, this percentage generally dropped rapidly or was at much lower levels--providing room for additional borrowing to support expanding business capital outlays and housing.

While debt formation by the private sector may proceed at a somewhat more rapid pace this year than in 1983, the expected pickup is modest by standards of earlier recoveries. That expectation is partly a reflection of the fact that the massive federal presence in the credit markets, unlike the pattern in previous expansions, will continue to absorb the bulk of the net saving available to the domestic economy. As illustrated in the shaded area in the top panel of the chart on the next page, the federal deficit over the

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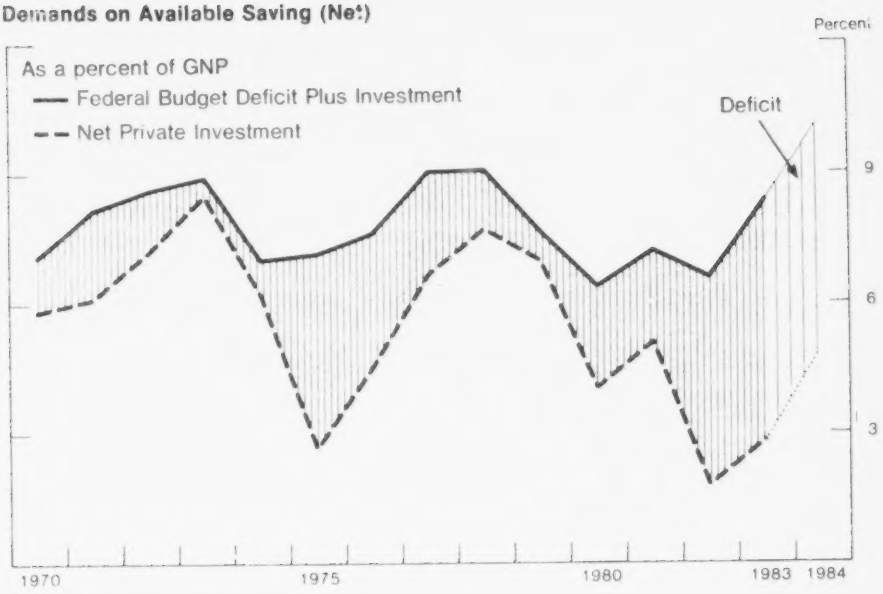
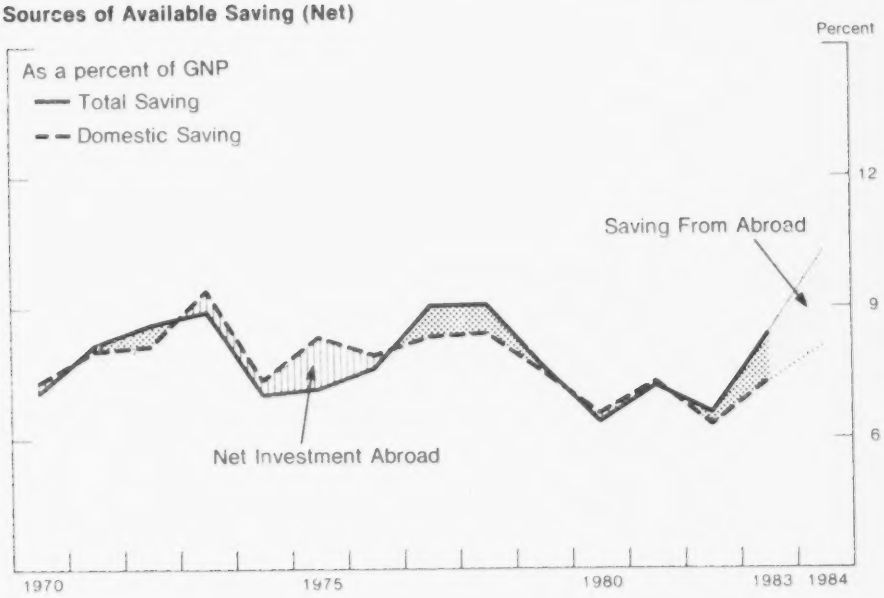
Demands on Available Saving (Net)



Sources of Available Saving (Net)



Note: 1984 figures based on FOMC members' projections for the economy and estimates of the federal budget. Saving from abroad essentially equals the current account deficit.

past two years absorbed an unusually large proportion of the saving available to the domestic economy, and this will continue into 1984. The availability of domestic saving to finance the growing federal deficit and expanding private investment has remained limited, and expansion of total saving in line with financing needs last year was dependent on large increases in net funds obtained from abroad. Further such increases will again be required this year, as shown in the bottom panel of the chart. And if present trends continue, the government will continue to drain off much more of the nation's domestic saving than at any time in the preceding three decades, apart from the first year of recovery of 1973-75 recession.

The persistence of large deficits in the face of strengthening private credit demands would tend to exert pressures on domestic credit markets, keeping interest rates higher than they otherwise would be. Put another way, they are an offset to other forces working toward lower interest rates. These pressures stemming from the federal deficit work to restrain expansion in areas of the economy that are more sensitive to interest rates--such as housing, autos, and long-term business capital spending. They also--to the extent higher interest rates lead to a strong dollar on exchange markets--retard our export industries. And, finally, high interest rates contribute to strains on the domestic and international financial system from the lingering heavy indebtedness incurred during inflationary expansion of earlier years.

Actions taken to reverse the upward trend in the structural budgetary deficit clearly would work to reduce potential credit market pressures, to help assure a balanced and sustainable economic expansion, and to promote a more orderly readjustment of our balance of payments position. The timing and magnitude of the favorable impact naturally would depend on the scheduling,

force, and prospective "carry through" of any action to reduce the budgetary deficit as well as on the surrounding economic environment.

Ordinarily, the principal effect of a lower budget deficit on credit markets and the economy would be expected to occur as the programs--whether on the spending or tax sides--actually become effective. Gains could occur earlier, however, in anticipation of reduced federal credit demands. For example, actions taken this year that would clearly reduce structural federal deficits beginning in fiscal years 1985 and 1986 could work in some degree in 1984 to lower interest rates, particularly longer-term rates. This would result from favorable effects on inflation expectations as well as the anticipated relief from the weight of governmental pressure on credit markets.

A decline in the structural federal deficit would in the first instance reduce one source of economic stimulus. However, any such effects should be associated with lower interest rates than otherwise, encouraging offsetting increases in spending by businesses and households for capital goods, homes, and consumer durables.

The positive effects from small reductions in the federal deficit would be difficult to isolate in our large, active credit markets. However, as structural deficits are reduced by substantial accounts--say by $50 billion to $100 billion--the counterpart rise in private credit may be most noticeable initially in mortgage markets at the lower long-term interest rates that are likely to evolve. In addition, businesses would be in a position to increase bond and stock offerings as they take advantage of the more favorable capital market atmosphere to improve their liquidity and balance sheet positions. Prospects for business spending for plant and equipment would be improved--an important factor in maintaining growth and productivity over the years ahead. As time went on, the export sector of the economy also should benefit as an aspect of the readjustment in our present unbalanced external position.

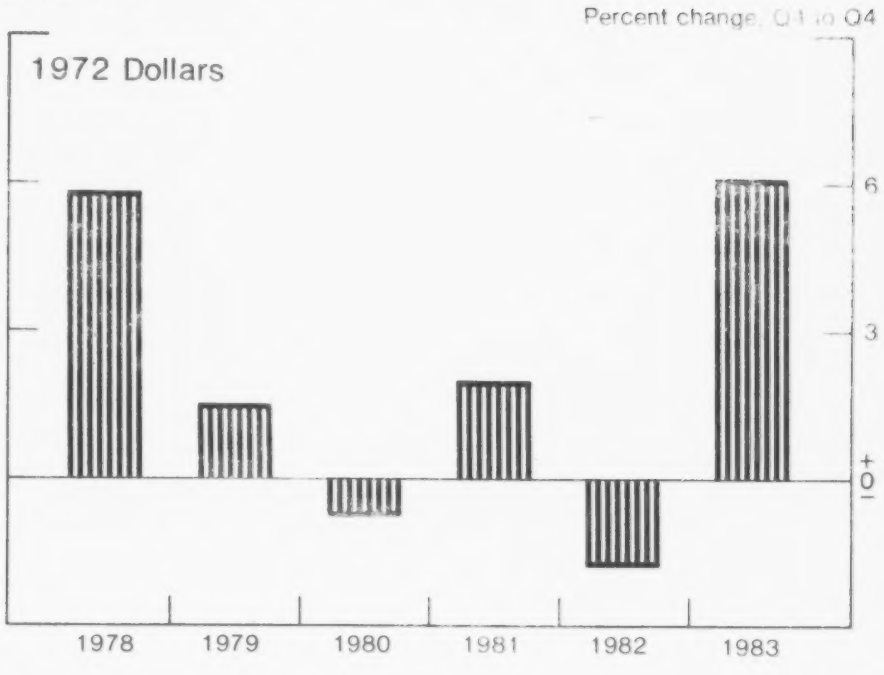
Section 3: The Performance of the Economy in 1983

Output and employment registered sharp gains in 1983, lifting the economy out of one of the most severe recessions since World War II. These gains brought a considerable reduction in the unemployment rate, which fell 2-1/2 percentage points over the year to 8.2 percent by year-end. The first year of recovery was marked by broadly based increases in spending by consumers and businesses; these advances were stronger than generally anticipated, given the low confidence and historically high credit costs that prevailed as the year began.

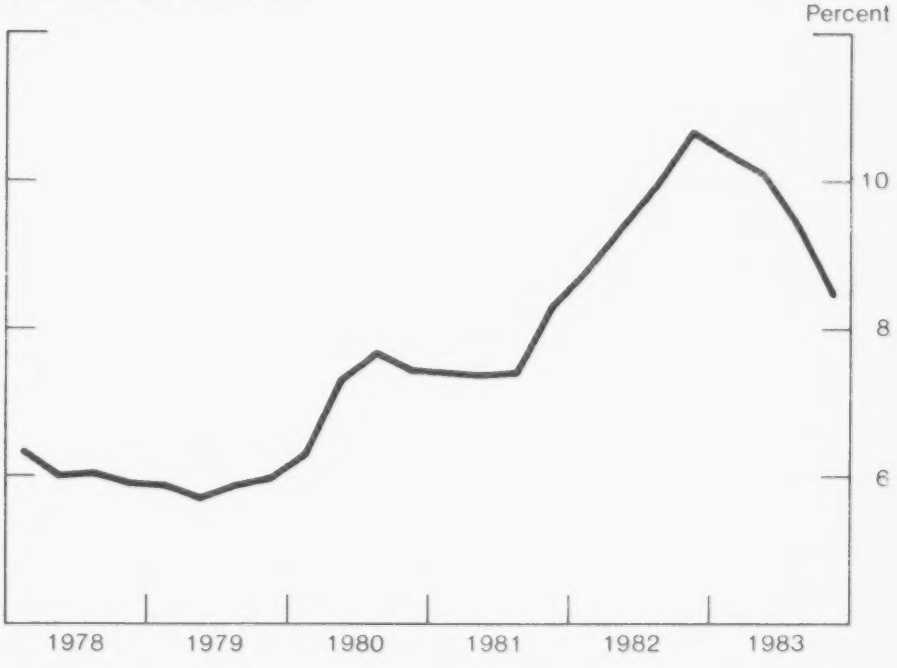
The impressive progress in reducing inflation in 1982 extended into 1983. The consumer price index rose 3-3/4 percent in 1983, the smallest increase in more than a decade. The continued slowing in inflation was aided by favorable price developments in energy markets and by the damping effect on food prices of abundant supplies of livestock products. However, 1983 also saw improvements in broader forces affecting prices and wages. With important lags, business and labor involved in key contract settlements seemed to be adapting constructively to the less inflationary environment, and overall wage and compensation increases were considerably smaller than during the previous year. At the same time, productivity improved, thereby helping to limit increases in unit labor costs, and average real incomes rose.

While the performance of the economy in 1983 marked a strong and encouraging advance toward the goal of sustained, noninflationary growth, several areas of concern remained. Although labor market conditions improved markedly, unemployment continued to be unacceptably high--especially for younger job seekers and minorities. In addition, 1983 saw a sharp--and worrisome--increase in the federal deficit. For the fiscal year ending in September, the deficit (not

Real GNP



Unemployment Rate



including off-budget programs) climbed to almost $200 billion. This deficit represented about 6 percent of GNP; the highest deficit so measured in the previous three decades had been 4 percent in 1976. The borrowing necessary to finance the deficit, in combination with continuing huge prospective government credit demands, exerted pressures on market interest rates--offsetting the effects of lower inflation and other factors--thereby tending to temper expansion of credit-sensitive private sectors of the economy.

Firms tied closely to world markets also did not share proportionately in the U.S. economic recovery in 1983. Large federal deficits and associated high domestic interest rates helped induce sizable inflows of foreign capital to the United States throughout the year and contributed to a further rise in the exchange value of the dollar. The strong dollar, in turn, put pressures on industries facing competition from foreign imports and, in an environment of sluggish economic growth in other countries, made it difficult for U.S. industries to sell their products abroad. Consequently, imports increased dramatically relative to exports in 1983; this shift had a significant moderating influence on the growth in domestic output.

The international debt situation remained a major concern in 1983. Some countries with serious debt problems made considerable progress in formulating and implementing internal adjustment policies, and they continued to receive a moderate flow of new financing. Nonetheless, historically high interest rates in the United States continued to place heavy burdens on the many developing countries with outstanding debt concentrated in dollars.

Financial Markets

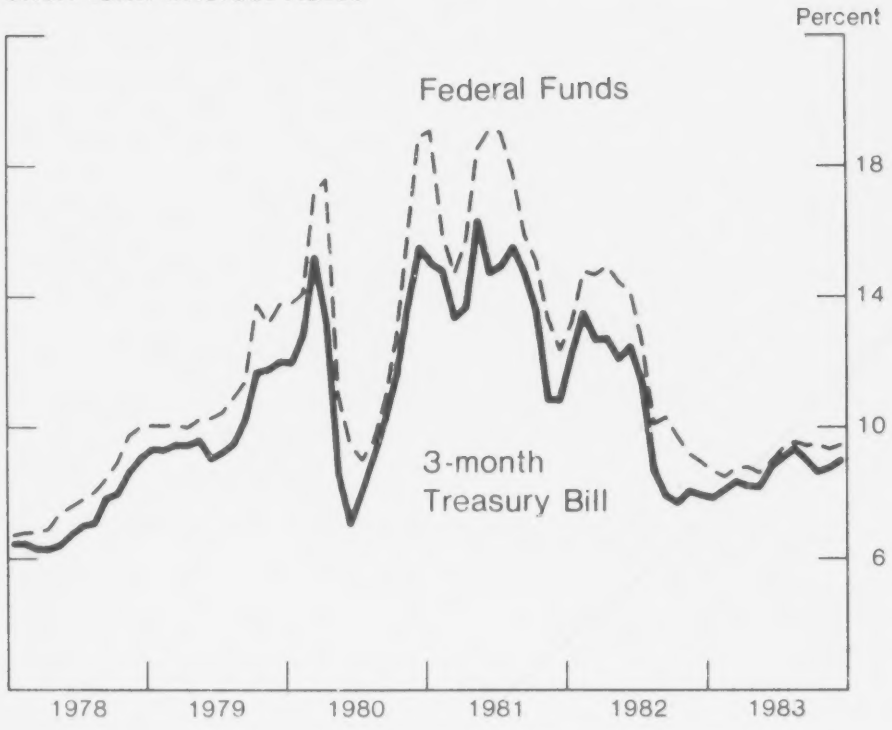
Partly reflecting the ready availability of funds from abroad, financial markets absorbed the increase in demand for credit associated with both

the financing of the record federal deficit and the upturn in the economy in 1983 without undue stress. In fact, interest rates were lower on average, and less variable, in 1983 than during the preceding few years, although most rates were somewhat higher at the end of the year than at the start.

Short-term yields were relatively stable early in 1983, following a marked decline during the second half of 1982. In late spring, economic growth accelerated sharply, and the monetary aggregates, looked at as a whole, were continuing to grow at a relatively rapid pace. In those circumstances, the Federal Reserve began to restrain somewhat its provision of reserves to depository institutions, and short-term interest rates rose moderately during the summer months. For the remainder of the year, most short-term rates fluctuated in a generally narrow range, ending 1983 around 1 percentage point higher than a year earlier.

The decline in long-term interest rates that had commenced in mid-1982 continued through the early months of 1983. These rates also began moving up in the spring, climbing fairly steadily through August. Thereafter, long rates fluctuated in a range somewhat above that of the first half of the year. At the end of 1983, long rates generally were 1 to 1-1/2 percentage points above their levels of a year earlier. Exceptions to this pattern were mortgage rates and yields on municipal bonds, which were down on balance from their levels at the close of 1982. Long-term interest rates remained quite high relative to the current rate of inflation throughout 1983; continuing uncertainties regarding the speed of the economic expansion and its possible implications for future inflation, as well as concerns about the outlook for federal deficits, were factors.

Short-term Interest Rates



Long-term Interest Rates

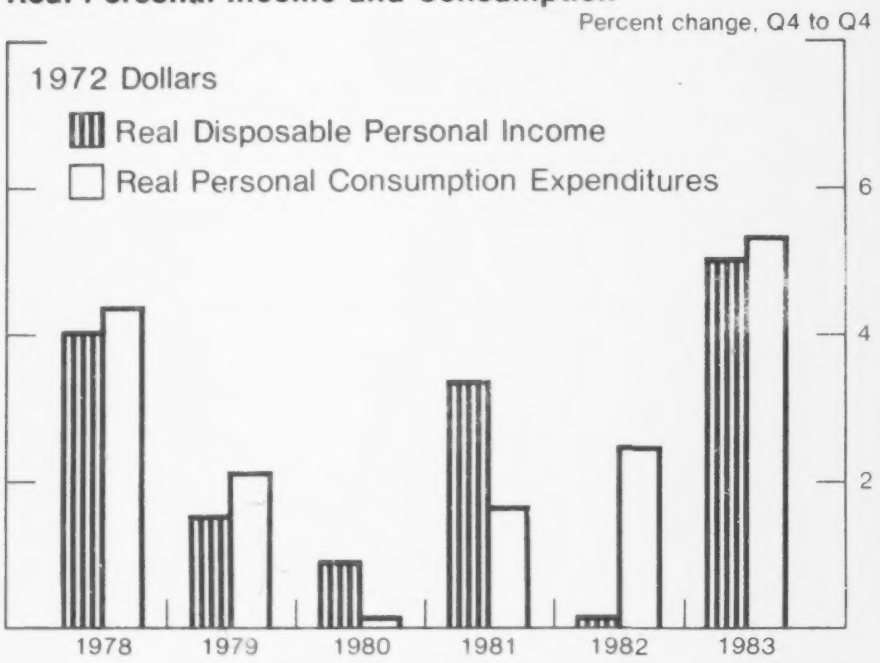
Household Sector in 1983

Most households experienced financial and economic gains in 1983. With unemployment down and gains in employment sizable, growth in personal income rebounded smartly during the past year. Further deceleration of inflation, lower interest rates, and the cumulative 25 percent reduction in federal tax rates on personal income during the past three years all helped raise the purchasing power of household income. In addition, household net worth rose substantially in 1983, primarily reflecting the surge in stock market prices that began in 1982 and carried into 1983.

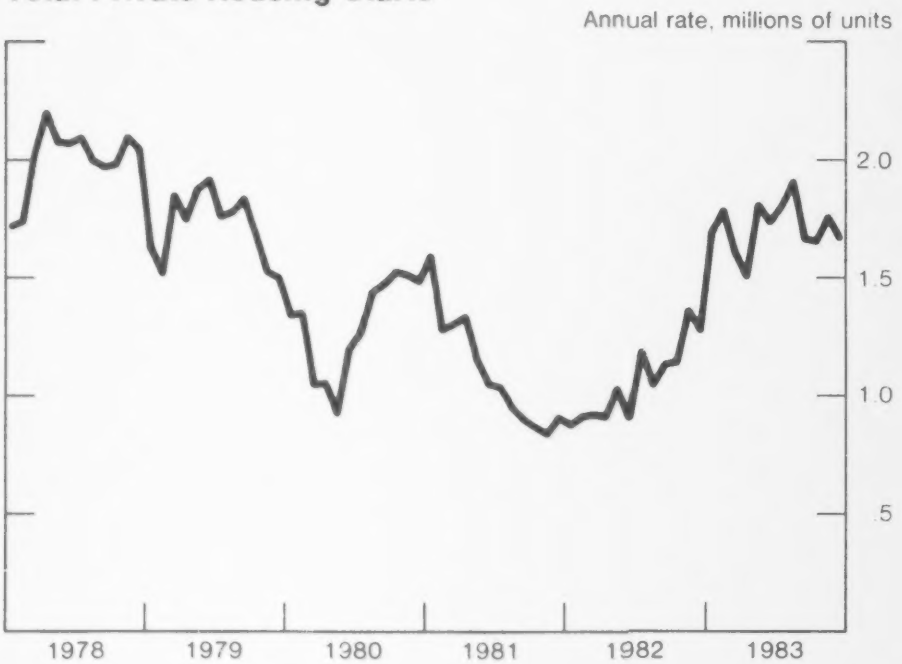
These gains no doubt were instrumental in boosting consumer confidence, which surveys indicated rose sharply in 1983 to its highest level in a decade. This improved mood encouraged households to finance major purchases by borrowing and to devote a larger proportion of current income to consumption rather than saving. As a result, the personal saving rate fell from 5.8 percent of disposable income in 1982 to 4.8 percent in 1983.

The improved economic and financial status of households fostered a substantial upswing in consumer spending. Much of the strength came in the automobile sector, as sales recovered from several years of sluggish performance. Sales of domestic models quickened in the first half of the year, spurred by financing incentives from dealers and lower rates on bank loans. Lower gasoline prices and the introduction of new and better American products also appeared to help. The recovery in domestic automobile sales continued through the second half of the year, despite the withdrawal of financing incentives. Sales of imported models, still constrained by import restrictions on Japanese models, edged up a bit in 1983, regaining their pre-quota (1980) level. Consumer spending for other goods and services also strengthened, paced by large

Real Personal Income and Consumption



Total Private Housing Starts



gains in housing-related items such as furniture and appliances as well as brisk advances in general merchandise and apparel sales.

Demand for housing surged in 1983, as early in the year long-term mortgage interest rates fell below 13 percent for the first time since the summer of 1980. The sharpness of the upturn reflected the considerable volume of demand postponed from the preceding few years of high credit costs and uncertain economic conditions. New housing construction rose considerably in response to rising sales during the first three quarters of the year. The rate of housing starts levelled off in the final quarter, influenced by the backup in mortgage interest rates during the second half of the year. However, for the year as a whole, total private housing starts rose 60 percent, the sharpest annual increase in almost 40 years. The construction activity generated by the increase in starts was an important factor in GNP growth, as is typical in the first year of an economic recovery.

The expansion in housing construction in 1983 was supported by increased lending by thrift institutions (where deposit growth was much improved) and by continued growth of secondary mortgage markets. The gains also reflected the popularity of financing techniques that provided homebuyers with initial interest rates lower than those quoted for fixed-rate, conventional loans. The record volume of tax-exempt, revenue bonds issued by states and localities last year to finance single-family mortgages provided many homebuyers with reduced-cost mortgage financing. Further, as market rates rose during the year, homebuyers increasingly switched to adjustable-rate mortgages. Many such instruments offered an initial rate advantage of 2 percentage points or more. By year-end, 55 percent of all conventional mortgage loans closed had a variable-rate feature of some kind. When mortgage rates were at their recent low

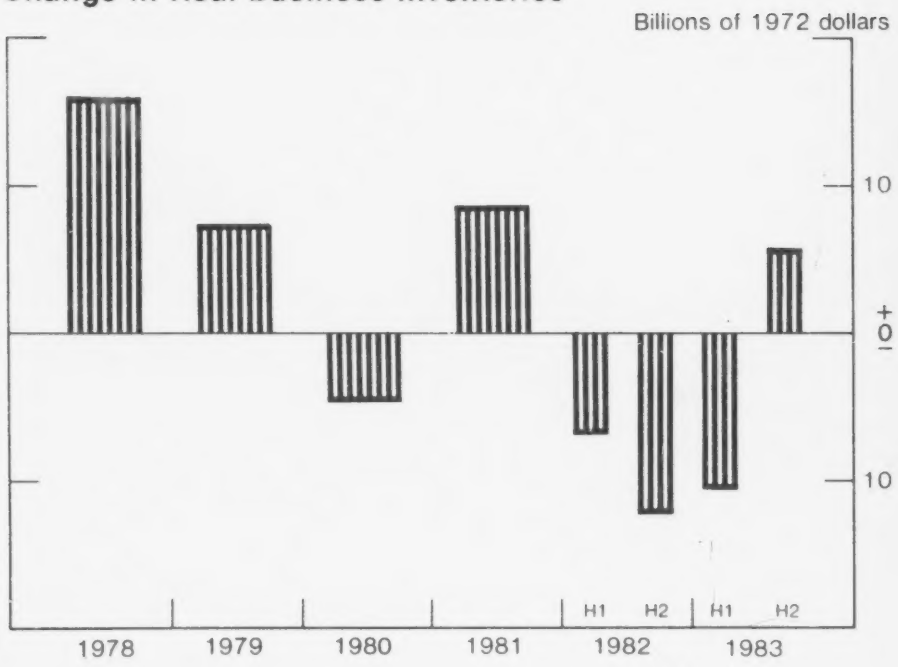
point in the spring of 1983, only 30 percent of conventional loans closed were adjustable. In addition, such interest-reducing mechanisms as builder buydowns and seller financing remained important features of housing finance during the year.

The Business Sector

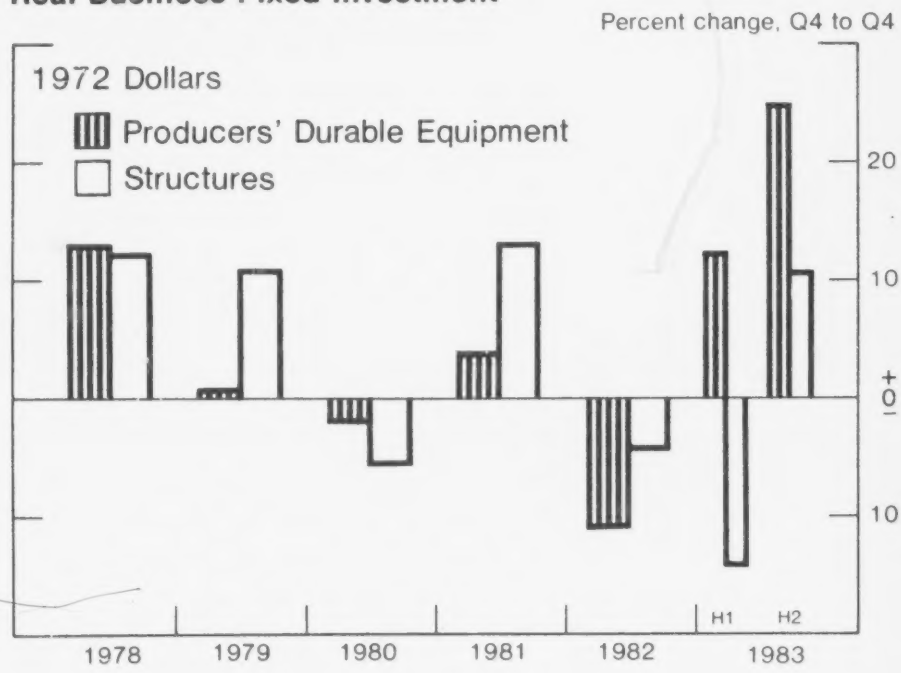
Economic and financial conditions in the business sector also improved markedly in 1983, as firms started the process of rebuilding their balance sheets from the recession. Sales and production rose sharply, bringing increased capacity utilization and productivity. These gains helped propel before-tax profits, which had been depressed in the early 1980s, to an unusually rapid increase for the first year of an economic expansion. With effective corporate tax rates lower, businesses were able to retain a larger proportion of their profits than in previous recoveries. Much improved cash flows and lower interest rates put firms in a much better position to service their outstanding debt in 1983. Further, the corporate sector improved its overall capital position in 1983 by issuing new stock in vastly improved equity markets. During the first half of the year firms strengthened their balance sheets by shifting borrowing toward longer maturities. However, historically high interest rates limited this adjustment, and rising credit costs later in the year sharply reduced the volume of long-term debt financing.

A marked shift in inventory investment from liquidation to accumulation took place in 1983, further boosting GNP. Firms had undertaken massive reductions in stocks during 1982 and early 1983. With final demands strengthening, inventory reduction slowed markedly in the second quarter of the year; and, after midyear, firms began to rebuild their inventories. With sales and shipments quite strong during the second half of the year, the actual stocks of

Change in Real Business Inventories



Real Business Fixed Investment



inventories remained quite lean, and inventory-sales ratios fell to historically low levels.

Business spending on plant and equipment did not reach its cyclical trough until the first quarter of 1983, but such expenditures grew rapidly throughout the rest of the year. Overall, business fixed investment increased almost 11-1/2 percent in real terms between the fourth quarter of 1982 and the fourth quarter of 1983. At year-end rising new orders and surveys showing that businesses planned higher investment spending suggested that the recovery in investment had developed momentum that would carry it into 1984.

The strength in investment spending was concentrated in the equipment sector early in 1983, especially in motor vehicles, high-technology office equipment, and computing machinery. The recovery in equipment spending became more broadly based as the year progressed, as it spread to traditional heavy equipment. Expenditures for new structures also turned up in the second half of the year, led by investment in stores and warehouses. Construction of new office buildings declined sharply during the first half of 1983 and held at that reduced pace during the second half of the year, as vacancy rates remained quite high.

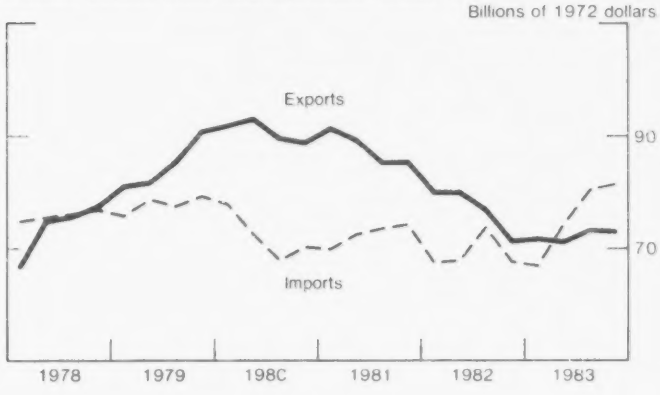
International Trade

The rising exchange value of the dollar was a major influence on U.S. exports and imports in 1983. On a weighted-average basis, the dollar rose an additional 10 percent during the course of the year, bringing the cumulative appreciation since 1980 to 50 percent. The sustained strength of the dollar has reflected economic policies here and abroad as well as the attractiveness of dollar investments in a time of international political and financial uncertainty.

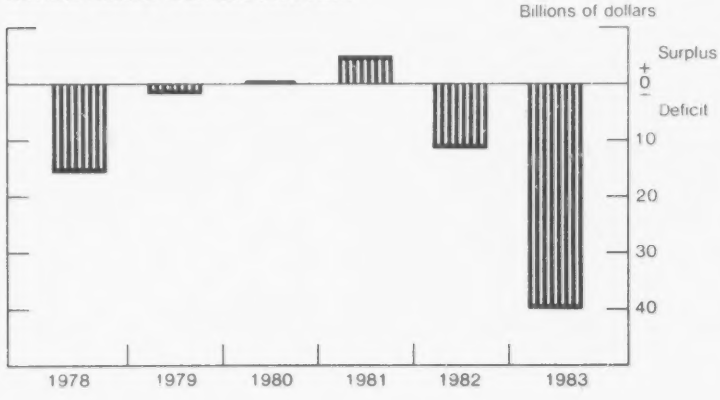
Despite a comparatively good inflation performance, the competitive position of firms in the United States eroded further in 1983. After declining

Exchange Value of the U.S. Dollar

United States Real Merchandise Trade Volume



United States Current Account



Merchandise trade volume for 1983 Q4 and current account for 1983 are estimated.

by more than 15 percent in 1982, the volume of U.S. exports remained weak last year. Exports to industrial countries, which account for almost two-thirds of the U.S. total, recovered somewhat in response to a moderate pickup in aggregate demand abroad. However, economic growth in many developing nations was limited by their debt service problems, and demand by those countries for imports from the United States remained depressed. In contrast, the vigorous expansion in the U.S. economy and the strength of the dollar pushed both the volume and the value of imports significantly higher. As a result, the U.S. trade deficit increased from an annual rate of about $45 billion in the fourth quarter of 1982 to a rate of about $75 billion in the fourth quarter of 1983. The U.S. current account registered a corresponding shift, with the deficit for the year reaching about $40 billion. Essentially, rapid increases in demand in the U.S. were partly satisfied by increasing imports, limiting gains in U.S. output.

The Government Sector

Government purchases of goods and services were lower in real terms in 1983 than in 1982. However, this decline stemmed largely from a reduction in crop inventories held by the Commodity Credit Corporation (CCC)--associated in part with the Payment-in-Kind (PIK) program. Excluding CCC, real federal purchases in 1983 were up 4-1/2 percent, led by a 5-1/4 percent increase in defense spending. Purchases by state and local governments picked up a bit, after two years of weakness induced by the recession and cutbacks in federal support.

An especially important development in the government sector in 1983 was the shifting fiscal positions of governments. The federal deficit ballooned to $195 billion in the fiscal year ending in September 1983. This

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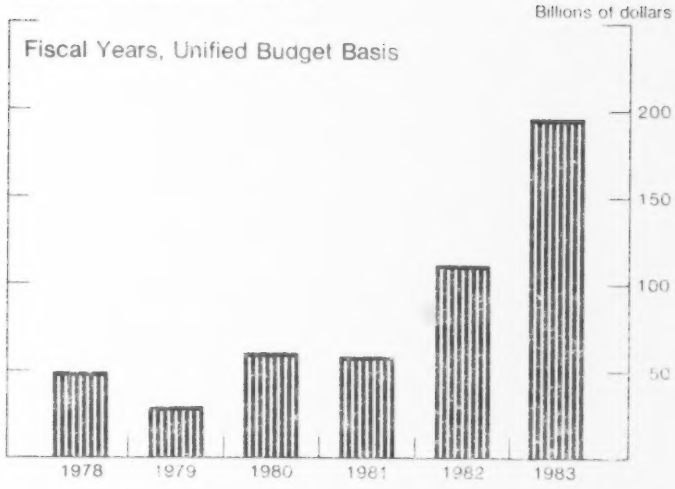
Federal Government Deficit



State and Local Governments

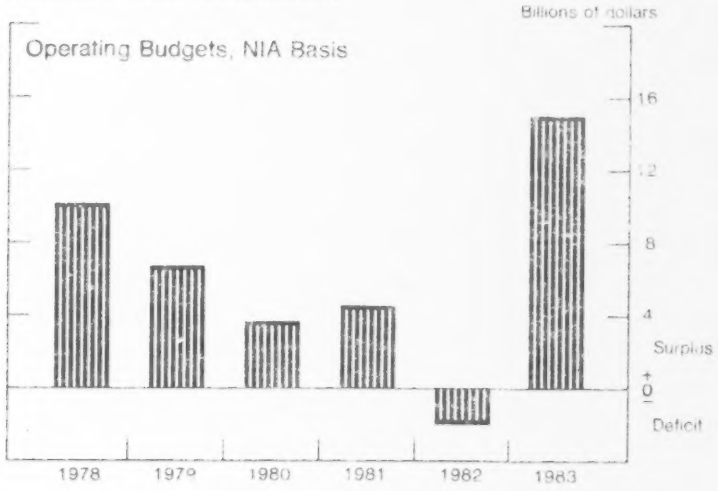


figure was nearly twice as large as the previous year's deficit, which itself was of record proportions. In part, the increase in the deficit in fiscal year 1983 reflected the lagged effects of the recession on receipts and transfer payments, but other factors also were important. Revenue growth was limited by the cumulative effects of three years of sizable tax reductions, and spending was buoyed by increases in outlays for defense, social insurance expenditures, and interest payments on national debt.

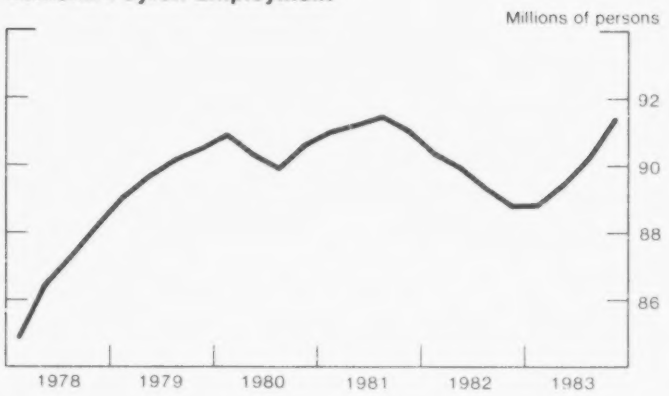
At the state and local level, operating budgets (excluding social insurance funds) moved dramatically from deficit into surplus. This shift resulted largely from the combination of tax increases and cost-cutting efforts adopted during the recession as well as an unanticipated increase in the tax base as the economy expanded at a surprisingly rapid pace.

Labor Markets

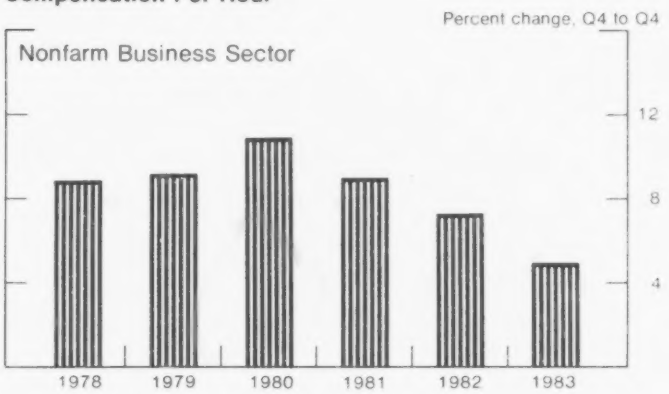
The recovery of production in 1983 was translated into an impressive improvement in labor markets. Three million workers were added to nonagricultural payrolls in the 12 months ending in December 1983. The most rapid gains were registered in durable goods manufacturing and in construction, the sectors hit hardest during the recession. Service jobs also contributed importantly to overall employment growth during the year.

Despite the rapid expansion in job opportunities, the rise in the labor force was relatively moderate, damped by the long-term slowing in the growth of the young adult population and by stability in labor force participation rates. As a result, the first year of the recovery was marked by an unusual concentration of hiring from the pool of those who reported that they had permanently lost their last job. Because such workers typically are out of work for extended periods, the number of long-term unemployed workers also fell sharply last year.

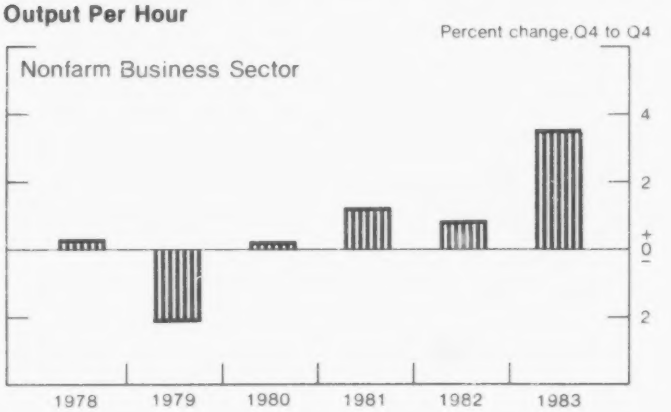
Nonfarm Payroll Employment



Compensation Per Hour



Output Per Hour



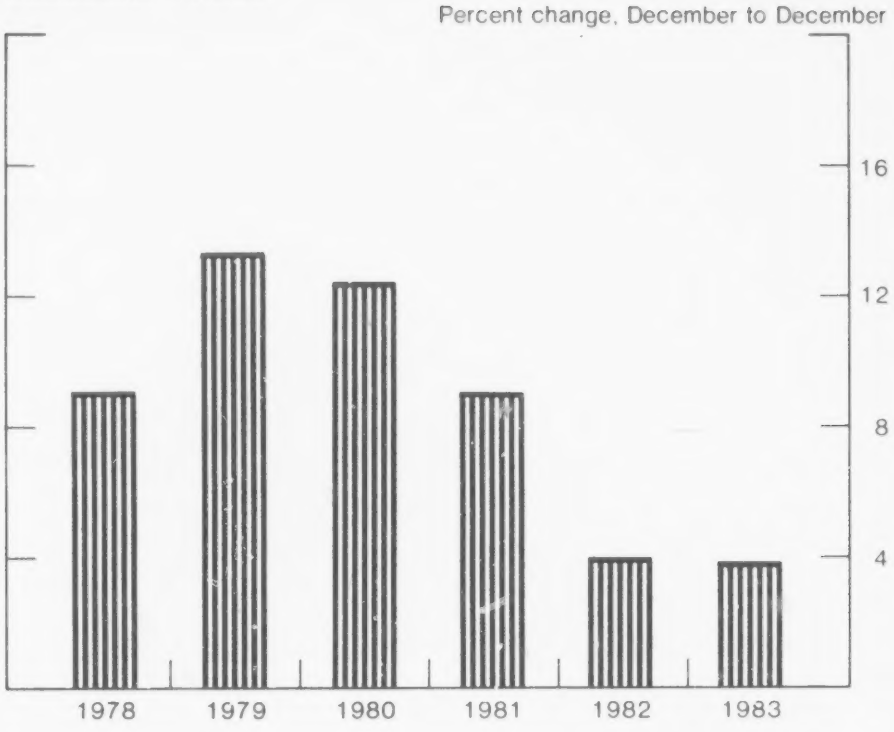
Nominal wage increases continued to decelerate in 1983. Hourly compensation rose at a rate of 5 percent over the four quarters of 1983--the slowest pace since 1965. The easing of wage increases reflected slack in labor markets in general as well as adjustments in several major collective bargaining agreements. Nearly 40 percent of workers who negotiated major union settlements during 1983 accepted wage freezes or outright pay cuts for the first year of their new contracts. As a result, the size of the "new settlements" component of union wage increases slowed to less than 1 percent. At the same time, cost-of-living adjustments slowed, reflecting the continued moderation in prices.

On average, however, wage gains in 1983 exceeded price increases, so that most workers experienced improved purchasing power. Rising real wages mirrored improvements in labor productivity. Although a good deal of the gain in output per hour worked was attributable to the pickup normal during the early stages of an economic recovery, there is reason to believe that longer-run improvements also were in train. Revisions in work rules at many establishments during the recession contributed to efficiency, and in 1983 both business and labor appeared to sustain their efforts to trim costs and improve quality. Reflecting wage and productivity developments, unit labor costs rose only 1-1/4 percent in 1983. This was the best performance since the mid-1960s.

Prices

The continued moderation in labor costs, a principal determinant of price movements, helped to unwind further the wage-price spiral that fueled inflation throughout the 1970s. Household surveys during 1983 revealed that, despite some increase in the second half of the year, expectations about inflation throughout 1983 remained lower than they had been in some time. Ample

Consumer Prices



Producer Prices

productive capacity and a strong dollar also contributed to further progress in reducing the rate of inflation.

That progress was reflected in most key price measures. Increases in the consumer price index remained in a much reduced range in 1983. The brighter inflation picture in part reflected transitory factors. Slack demand and large worldwide inventories caused a sharp decline in petroleum prices early in the year, and prices of food at the consumer level were relatively stable throughout 1983. However, the agricultural picture turned less favorable in the wake of the summer drought. The resulting depletion of grain stocks, coming on top of the effects of the federal government's PIK program designed to reduce agricultural production, put upward pressures on the prices of many agricultural commodities in the latter part of the year that can be expected to affect consumer food prices in 1984. In addition, severe December weather promised to adversely affect the supply of fresh fruits and vegetables early in 1984.

The deceleration of prices in 1983 was not limited to the food and energy sectors. The consumer price index excluding those sectors rose less than 5 percent--about half the pace of just three years earlier. Producer prices in general were little changed in 1983, as price increases of capital equipment as well as of consumer goods slowed markedly.

Section 4: The Growth of Money and Credit in 1983

In its reports to the Congress in February and July 1983, the Federal Reserve indicated that monetary policy during that year would be conducted with the aim of fostering a recovery in economic activity and encouraging further progress toward price stability. Establishing specific objectives for growth in the monetary aggregates was fraught with difficulties, however. Beginning in 1982, the behavior of M1 in relation to economic activity had diverged sharply from historical trends, raising doubts about the usefulness of that aggregate--at least over the near term--as a policy target; the effects of newly introduced Super NOWs and money market deposit accounts (MMDAs) on the behavior of M1 also were subject to considerable uncertainty. In addition, it was evident early in 1983 that M2 was being swelled by massive shifts of funds from outside that aggregate into MMDAs, but it was impossible to predict the precise timing and volume of such shifts.

Reflecting these special factors and uncertainties, in early 1983 the Federal Open Market Committee departed from past practice in establishing monetary objectives for 1983. The Committee agreed that the uncertainties regarding M1 continued to warrant the practice, began in October of 1982, of placing principal weight on the broader monetary aggregates--M2 and M3--in the implementation of monetary policy. Although the demands of the public for those aggregates might be affected by shifts in asset preferences that were rooted in regulatory changes or other causes, it seemed that such effects would be smaller and more predictable for the broader aggregates than for M1.

In the case of M2, an annual target range of 7 to 10 percent was established. The FOMC believed that performance of the aggregate would most appropriately be measured over a period when it would be less influenced by

the initial, highly aggressive marketing of MMDAs. Thus the Committee chose the average level of February and March as the base for measuring growth, rather than the fourth quarter, the period that generally had been used in the past. It was anticipated that the range for M2, which was 1 percentage point higher than the range for 1982, would allow for some residual shifting of funds to MMDA accounts over the remainder of the year.

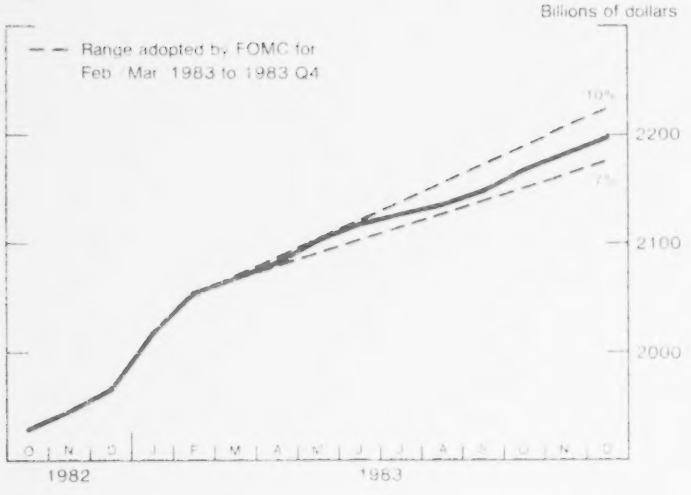
The range for M3, to be measured as usual from the fourth quarter to the fourth quarter, was established at 6-1/2 to 9-1/2 percent. This range was the same as that established in the previous year, but encompassed growth below the actual outcome in 1982. In adopting this range, the Committee assumed that any net shift of funds during the year into the new types of deposit accounts from market instruments would be largely offset by reductions in managed liabilities (such as large CDs) included in M3.

In light of difficulties in gauging the relation between transaction balances and economic activity, the range for M1 was set in February at 4 to 8 percent, a band 1 percentage point wider than usual. As noted above, the Committee agreed that, in implementing monetary policy, less than customary weight would be assigned to M1; instead, the Committee would rely primarily on the broader aggregates, at least until M1 had evidenced more regular and predictable behavior. Moreover, the Committee emphasized that, in implementing policy, the significance it attached to movements in the various monetary measures necessarily would depend on evidence about the strength of economic recovery, the outlook for prices and inflationary expectations, and emerging conditions in domestic and international financial markets.

The Committee also set forth for the first time its expectations for growth of the total debt of domestic nonfinancial sectors, indicating that a

Ranges and Actual Money Growth

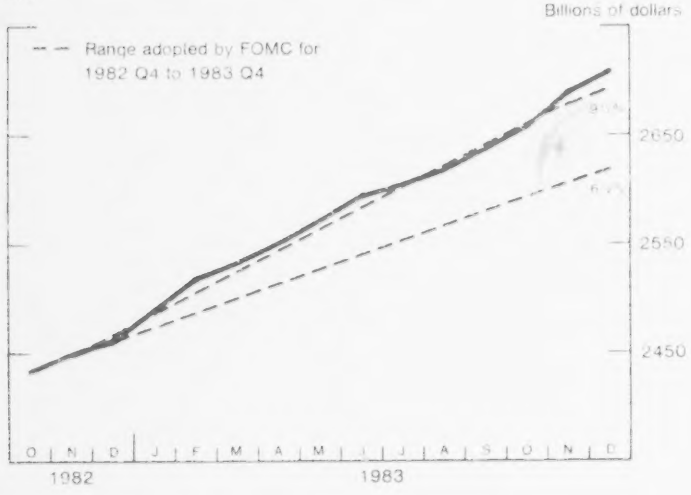
M2



Rate of Growth (annual rate)

Feb.-Mar. to 1983 Q4
8.3 percent

M3

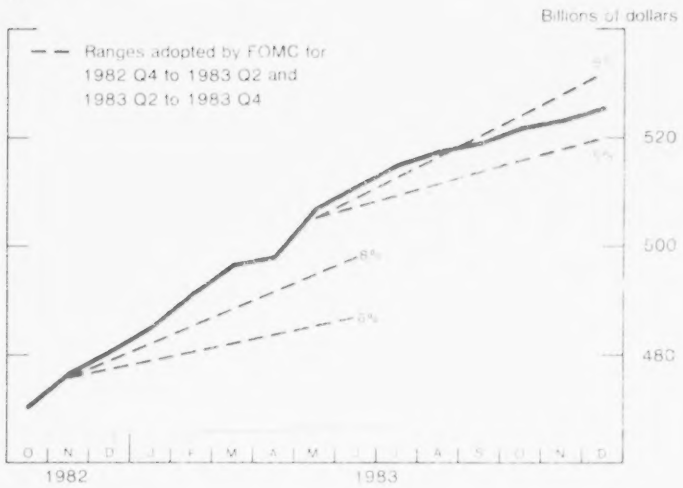


Rate of Growth

1982 Q4 to 1983 Q4
9.7 percent

Ranges and Actual Money and Credit Growth

M1

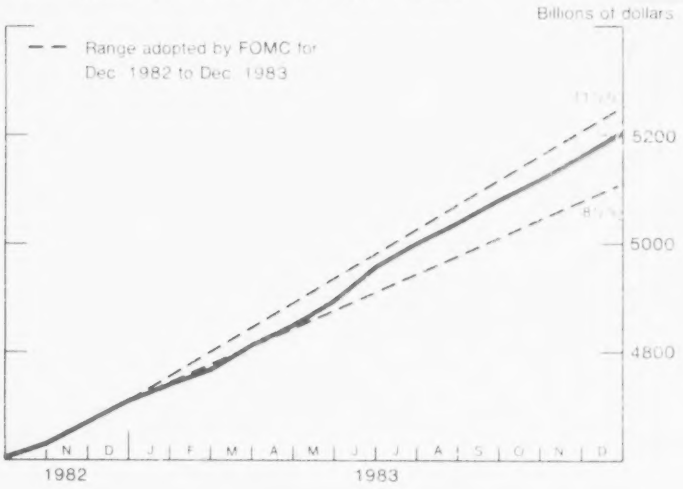


Rates of Growth (annual rate)

1982 Q4 to 1983 Q2
12.4 percent

1983 Q2 to 1983 Q4
7.2 percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth

Dec. 1982 to Dec. 1983
10.5 percent

range of 8-1/2 to 11-1/2 percent, measured from December 1982 to December 1983, would be appropriate. This range was thought to be about in line with expected growth in nominal GNP, reflecting the historically similar growth trends of each. It was recognized that, in the early stages of other postwar recoveries, growth in GNP had exceeded growth in debt by an appreciable margin; but in the current circumstances--including the financial condition of the private sector as the recession ended and the prospective huge volume of federal borrowing--expansion in the debt aggregate might run in the upper half of the stated range during 1983.

The behavior of M1 in early 1983 continued to diverge from precedents. (The analysis here--as elsewhere in this section--is based on recently revised data for the monetary aggregates, but the same finding holds for the data that were available during 1983.)[1] As apparently was the case during the second half of the previous year, precautionary motives stemming from highly uncertain employment and income prospects evidently continued to swell demands for liquid balances relative to the rate of spending on goods and services; in addition, the lagged effects of earlier declines in interest rates contributed to increased demands for money. M1 expanded rapidly through late spring; growth was dominated by its highly liquid, interest-earning other checkable deposit (OCD) component. Growth in OCDs during the first half of the year accounted for more than half of the expansion in M1, a contribution well out of proportion to the importance of this component. In turn, inflows to Super NOW accounts, which had been authorized in early January, exceeded growth in OCDs during the year as a whole. Even so, the introduction of the new deposit accounts appears in retrospect to have

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1. Appendix B to this report provides detailed information on the recent benchmark and seasonal adjustment revisions of monetary data for 1983, as well as on the impact of a redefinition of M3 to include term Eurodollars.

had little effect on the overall growth rate of M1, as inflows from outside M1 into Super NOWs probably were roughly offset by outflows from M1 to MMDAs.

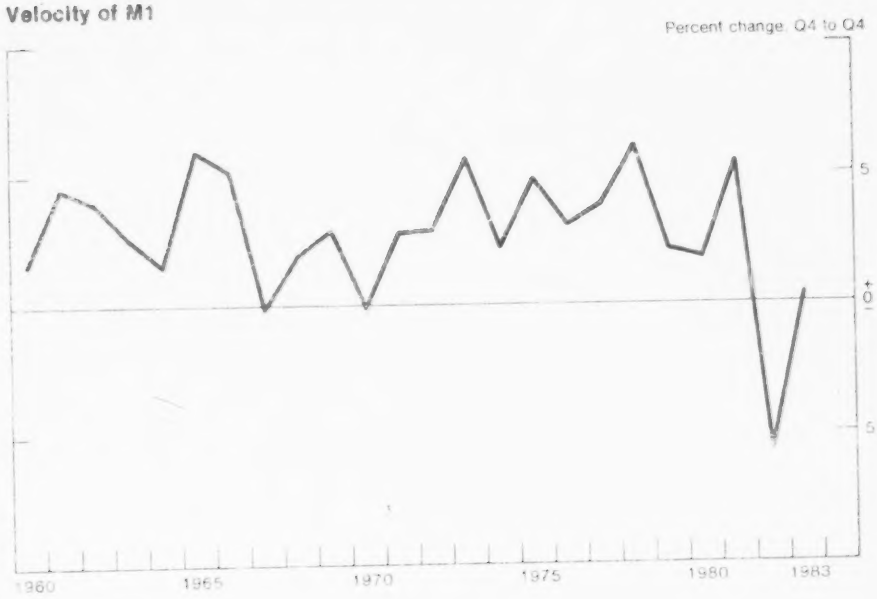
In light of the rapid expansion in M1 through midyear, and referring back to its recognition that appropriate growth rates for the aggregates would depend on judgments about unfolding economic and financial developments, the FOMC in July established a new monitoring range for M1 for the second half of 1983. This range of 5 to 9 percent was based on the average for the second quarter, rather than that for the fourth quarter of 1982. The decision to adopt a new base for monitoring M1 growth reflected a judgment that the recent rapid growth of M1 would appropriately be treated as a one-time phenomenon which was expected to be neither reversed nor extended. It appeared, in retrospect, that the surge in M1 might largely have reflected an adjustment by the public of its cash balances in response to the pronounced drop in the opportunity cost of holding low-yielding demand deposits and regular NOW accounts. The FOMC emphasized that it still regarded the behavior of M1 as subject to substantial uncertainties, and it reaffirmed its decision to place principal weight on the broader aggregates in the implementation of monetary policy.

After midyear, precautionary demands for liquid balances apparently began to abate, reflecting improved confidence arising from the recovery; a moderate rise in interest rates, which began in late spring, also curbed demands for money. Demand deposits peaked in July and edged down, on balance, during the second half; the growth of OCDs fell to a fraction of the rapid first-half pace. Thus M1 entered its newly established monitoring range in late summer and finished the year in the middle of that range.

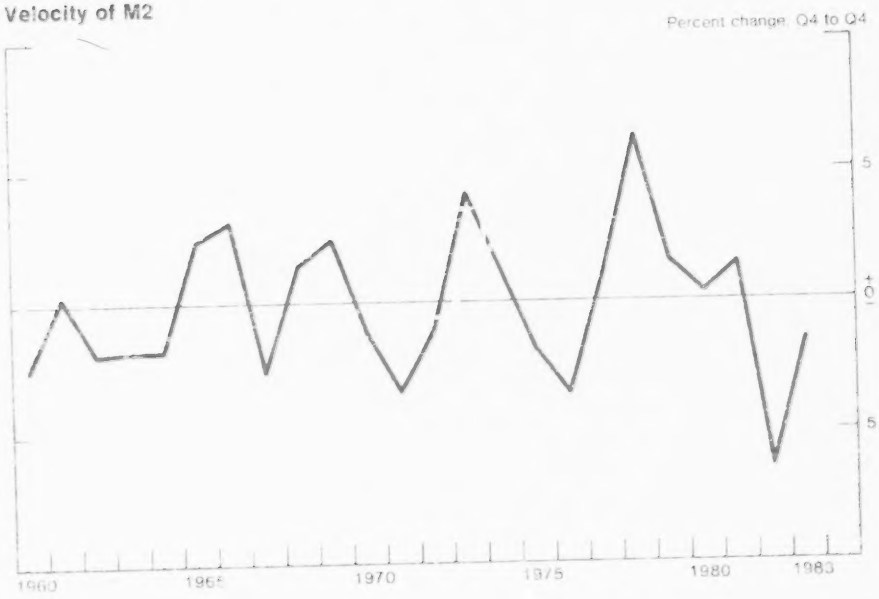
During the first quarter of 1983, the velocity of M1 continued to decline at nearly the extraordinary rate of 1982. These declines exceeded

Growth in Velocity*

Velocity of M1



Velocity of M2



*Velocity equals GNP divided by M1 or M2

GROWTH OF MONEY AND CREDIT[1]
Percentage changes

Period	M1	M2	M3	Domestic nonfinancial sector debt[3]
Base to fourth quarter[2]				
1983	7.2	8.3	9.7	10.5
Fourth quarter to fourth quarter				
1978	8.2	8.0	11.8	13.0
1979	7.5	8.1	10.3	12.0
1980	7.4	9.0	9.6	9.5
1981	5.1 (2.5)[4]	9.3	12.3	9.6
1982	8.7	9.5	10.5	9.2
1983	10.0	12.1	9.7	10.5
Quarterly growth rates				
1983--Q1	12.8	20.5	10.8	8.8
Q2	11.6	10.6	9.3	12.0
Q3	9.5	6.9	7.4	9.9
Q4	4.8	8.5	10.0	9.8

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions. M3 incorporates a definitional change as well, the inclusion of term Eurodollars. See appendix B to this report for detailed information.
2. The base for measuring growth in M1 was the second quarter of 1983; for M2, February-March 1983; for M3, the fourth quarter of 1982; and for domestic nonfinancial sector debt, December 1982.
3. Growth rates of domestic nonfinancial sector debt are measured between last months of periods.
4. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

those implied by models of past behavior, even taking into account the effects of the large reduction in the opportunity cost of holding money balances brought about by sharp drops in market rates and the introduction of ceiling-free Super NOW accounts. As the year progressed, the velocity of M1 began to increase, slowly at first but more rapidly by the last quarter. Even with this acceleration, growth in M1 velocity in the full year following the business cycle trough in the fourth quarter of 1982 was well below the experience typical in a recovery.

As was evident when the target ranges were first established early in 1983, the dramatic response to the authorization of MMDAs substantially boosted M2. Competition for these funds was intense: promotional activity was heavy and, in some regions, introductory interest rates were far above yields on market investments. Inflows to MMDAs in January alone totaled $147 billion, and by March outstandings had reached $321 billion. However, most of the inflow to MMDAs appears to have come from other instruments included in M2. Analysis by the Board's staff suggests that as much as four-fifths of that inflow may have been transferred from savings deposits, small time deposits, and money market mutual funds. (Over the course of the year, assets of money market mutual funds dropped 25 percent.) Still, a sizable volume of funds came from outside M2 and had an evident impact on growth in that aggregate.

In the face of the heavy deposit inflows and relative sluggishness of business loan demand at commercial banks, institutions dropped their aggressive promotion of MMDAs. The aggregate level of MMDAs barely increased after June, reflecting a sharp drop in interest rates offered on these accounts. At the same time, the less liquid small time deposit component of M2 increased quite rapidly over the second half of the year, as a result of the steepening yield

curve and more attractive rates on such deposits. However, the removal on October 1 of all remaining restrictions on small time deposits with original maturities or notice periods longer than 31 days had little noticeable impact on deposit flows.

Reflecting MMDA inflows, M2 growth from the fourth quarter of 1982 through the fourth quarter of 1983 was 12 percent. However, from the February-March period used by the FOMC as the base for its target growth range, expansion through the fourth quarter was at an 8-1/4 percent annual rate, well within its range.

After declining at a record rate in the first quarter, M2 velocity rose during the rest of the year; over the year as a whole, velocity fell slightly. As was the case for M1, the velocity of M2 failed by a wide margin to keep pace with the average increase during the first year of a business recovery. However, correction for the volume of funds thought to have been attracted to MMDAs from outside M2 suggests that velocity movements were in reasonably close correspondence with experience.

M3 growth picked up a bit in the first quarter from its late 1982 pace, owing to the explosion in M2. But until the closing months of the year, expansion in this aggregate was restrained by sharp runoffs in managed liabilities--especially large CDs--in response to the rapid buildup early in the year of MMDA balances and limited loan demand at commercial banks. On the other hand, thrift institutions continued to issue large CDs at a rapid pace in response to robust mortgage demands and a cost incentive to pay down advances from the Federal Home Loan Banks. On balance, M3 moved on a track near the upper end of its target range during 1983; growth from fourth quarter to fourth quarter was 9-3/4 percent, just outside the target range.[1]

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1. M3 has been redefined to include term Eurodollars, previously included only in the aggregate L.

Domestic nonfinancial sector debt increased 10-1/2 percent in 1983, a bit above the pace of the previous year. The outstanding debt of the federal government grew almost 20 percent, about matching the pace of 1982; this expansion accounted for about 40 percent of the increase in all domestic nonfinancial debt last year. State and local government financing activity surged to a new record; some of the borrowing reflected efforts on the part of the issuers to market debt before the imposition of anticipated constraints, including requirements for bond registration and proposed limits on revenue bond issuance. A stepped-up pace of investment in housing and consumer durables led to a near-doubling of borrowing by the household sector. But issuance of nonfinancial business debt slowed to a quite low pace, as internal cash flows of corporations exceeded capital expenditures for much of the year and relatively high stock prices encouraged issuance of new equity shares.

The proportion of credit intermediated by depository institutions grew substantially, rising from about one-third in 1982 to about one-half in 1983. This increase reflected both the impact of MMDA inflows and a surge in mortgage demands. Funds advanced by thrift institutions, in particular, rose sharply from a depressed 1982 pace. Commercial bank credit also expanded more rapidly in 1983; purchases of government securities accounted for more than one-third of net credit extended by banks. Attracted by relatively high U.S. interest rates, funds advanced by the foreign sector also increased substantially during 1983.

Thus each of the monetary and credit aggregates finished the year close to or within the ranges set by the FOMC. (Indeed, for the data prior to the recent benchmark, seasonal, and definition revisions, all of the money stock measures were well within their ranges at the end of 1983.) Achievement of these

objectives and the broader goals of the Federal Reserve was brought about by relatively small changes in the reserve position of the banking system and was accompanied by generally stable conditions in financial markets. Interest rates fluctuated far less than in the previous few years. Moreover, although most interest rates rose moderately during the year as the economic recovery progressed, on average interest rates were substantially lower in 1983 than in 1982. For example, rates on level-payment home mortgages averaged nearly 3 percentage points below their 1982 levels; business borrowing costs, likewise, declined significantly.

Other indicators attested to a greater degree of stability and confidence in financial markets and the economy. Broad measures of stock prices increased about 20 percent. The balance of bond downgradings and upgradings by the principal rating agencies became much more favorable. Spreads between interest rates on private and federal government debt obligations narrowed dramatically during 1983, as did spreads between yields on lower- and higher-rated private securities. The strong stock market enabled many large firms to strengthen their balance sheets and many young companies to make initial public offerings of their shares.

Commercial banks adapted to important changes in their environment in 1983. The new deposit accounts were successful in attracting funds to both banks and thrift institutions. At the same time, banks experienced relatively soft demand for business loans--especially in the first half of the year--and, hence, invested heavily in government securities, other market instruments, and loans to consumers. However, credit problems intensified in energy-related businesses, and the financial condition of a number of foreign borrowers remained troubling. A widespread increase, relative to historical experience, occurred

in loan-loss provisions. A sizable number of banks--mostly small--experienced credit-quality problems so severe that they were closed or merged into other institutions. Nonetheless, earnings of commercial banks in general appear to have been well maintained in 1983.

The condition of the thrift industry began to improve last year as lower average interest rates significantly reduced operating losses. As a result of the MMDA, these institutions have enjoyed a substantial increase in core deposits, and their improved profit position has enabled them to expand large time deposits at reasonable cost. In contrast to commercial banks, thrift institutions saw a heavy demand for loans last year. For the first time, in 1983 a large proportion of mortgages that they made carried adjustable rate features, thus repairing some of the severe mismatch in asset and liability durations. Nevertheless, profit positions remain marginal and highly sensitive to changes in interest rates.

Appendix A

Federal Reserve Press Release

of January 13, 1984

Regarding Contemporaneous Reserve Requirements

Beginning Thursday, February 2, the new contemporaneous reserve requirement (CRR) system will become effective. In that connection, questions have been raised about the implications of this change for the Federal Reserve's open market operating procedures. This issue has been considered by the Federal Open Market Committee. Taking account of technical transitional uncertainties as well as policy judgments about the role of M1 and other monetary aggregates under current circumstances, the Committee agreed to make no substantial change in current operating procedures at this time.

Background

The new CRR system differs from the present lagged reserve requirement structure in two principal ways. First, required reserves against transactions deposits will have to be held on an essentially contemporaneous basis, instead of being lagged by two weeks. Second, the reserve holding period has been lengthened from one week to two weeks (with the relevant period for deposits also lengthened to roughly the same two weeks--the 2-week deposit period running from Tuesday to the second Monday, and the reserve period running from Thursday to the second Wednesday).

This structural change in the reserve accounting system has tightened the linkage between reserves and the current behavior of transactions deposits--demand deposits and interest-bearing accounts with full checking privileges (NOW and similar accounts). These deposits, along with currency, held by the public, comprise M1, the measure of money most nearly related to the transactions needs of the economy. But because of NOW and similar accounts, which have grown substantially in volume over the past few years, M1 is also affected by saving propensities and patterns. The Committee

has been placing less weight than formerly on M1 because of the institutional changes that have altered its composition, affected its behavior, and increased uncertainties about its relationship to the economy.

Other, broader aggregates--M2 and M3--encompass M1 plus other highly liquid assets and forms of saving, such as money market funds accounts and time and savings deposits held at banks and thrift institutions. Some of these other assets also, in one degree or another, serve transactions purposes, though they are not, by law, subject to transactions reserve requirements. In general, the bulk of the assets in the broad aggregates are not subject to reserve requirements, although nonpersonal time deposits bear a relatively small lagged requirement.

Open market operations and CRR

Adaptations in open market operating procedures to CRR must take account of certain technical and transitional issues as well as the policy issue about the weight to be given M1 and other monetary aggregates in operations. The more technical and transitional issues involve how the depository system as a whole adjusts to the new reserve requirement system--which may influence demands for excess reserves, attitudes toward the discount window, and the speed of asset and liability adjustments generally. It can be expected that some time will elapse before banks and other depository institutions have fully adjusted their reserve management, as well as portfolio and liability management, to the new system. Money managers have to become accustomed to operating without certain knowledge of their required reserves for a full reserve averaging period during most of that period. In addition,

usual start-up problems with new data systems will probably add to uncertainties at least for a while. Such data problems would also affect the timing and reliability of figures available to the Federal Reserve.

These technical issues aside, the new reserve requirement structure would potentially permit somewhat closer short-term control of M1 in particular. With CRR, if open market operations were geared primarily to M1, an "automatic" tightening or easing of reserve positions that worked to bring M1 under control would tend to occur somewhat more promptly than with lagged reserve accounting.

Whether operating procedures should be adapted for this purpose does not depend on the technical characteristics of the reserve requirement system in place but rather on broader policy judgments about the relative weight to be given to M1 as a target and the desirability of seeking close short-run control of that aggregate. To the extent less weight continues to be placed on M1, and relatively more on broader aggregates less closely related to reserves, "automatic" changes in reserve pressures in response to short-run movements in M1 alone may not be appropriate.

In light of these various considerations, the Committee agreed that no substantial change would be made in open market operating procedures at this time. These operating procedures will be reviewed after a transitional period in the context of the role played by the monetary aggregates, particularly M1, in policy implementation and the potential implicit in CRR for achieving closer short-run control of M1.

Appendix B

Money Stock Revisions

Measures of the money stock have been revised to reflect annual seasonal factor and benchmark revisions, as well as a definitional change affecting M3. This appendix discusses these revisions and presents tables comparing growth rates of the old and new series.

Definitional Change

The definition of M3 has been changed to include term Eurodollars held by U.S. residents in Canada and the United Kingdom, and at foreign branches of U.S. banks elsewhere. A recent reporting change provides data on term Eurodollars at a panel of branches of large U.S. banks on a schedule similar to other M3 elements. The inclusion of term Eurodollars raised the level of M3 by about $90 billion but had a minimal effect on M3 growth in 1983.

Benchmark Revisions

Deposits have been benchmarked to recent call reports; further revisions to deposits stem from changes to System reporting procedures made in 1983, largely related to reduced reporting under the Garn-St Germain Act of 1982. In addition, the currency component was revised to reflect revisions to figures on the amount of coin in circulation. The net impact of these revisions was to raise the levels and boost the growth rates of each of the aggregates in 1983.

Seasonal Revisions

Seasonal factors have been updated using the X-11 ARIMA procedure adopted in 1982. Nontransactions M2 has been seasonably adjusted as a whole--instead of being built up from seasonally adjusted savings and small time deposits--in order to reduce distortions caused by portfolio shifts arising from financial change in recent years, especially shifts to MMDAs in 1983. A similar procedure has been used to seasonally adjust the non-M2 portion of M3.

COMPARISON OF REVISED AND OLD M1 GROWTH RATES
(percent changes at annual rates)

	Revised M1 (1)	Old M1 (2)	Difference (1-2) (3)	Difference due to Benchmark (4)	Difference due to Seasonals (5)
Monthly					
1982--Oct.	17.3	14.2	3.1	0.5	2.6
Nov.	15.8	13.6	2.2	0.8	1.4
Dec.	10.3	10.6	-0.3	-0.4	0.1
1983--Jan.	11.5	9.8	1.7	-2.4	4.1
Feb.	14.8	22.4	-7.6	0.2	-7.8
Mar.	13.0	15.9	-2.9	0.0	-2.9
Apr.	3.6	-2.7	6.3	1.7	4.6
May	21.0	26.3	-5.3	0.5	-5.8
June	10.2	10.2	0.0	1.4	-1.4
July	9.4	8.9	0.5	0.9	-0.4
Aug.	5.8	2.8	3.0	0.0	3.0
Sept.	3.5	0.9	2.6	0.6	2.0
Oct.	6.2	1.9	4.3	1.6	2.7
Nov.	3.2	0.9	2.3	0.0	2.3
Dec.	5.3	6.5	-1.2	-1.0	-0.2
Quarterly					
1982--QIV	15.4	13.1	2.3	0.2	2.1
1983--QI	12.8	14.1	-1.3	-0.7	-0.6
QII	11.6	12.2	-0.6	0.8	-1.4
QIII	9.5	8.9	0.6	0.8	-0.2
QIV	4.8	2.1	2.7	0.6	2.1
Annual					
1983--QIV '82 to QIV '83	10.0	9.6	0.4	0.4	0.0
Semi-Annual					
QIV '82 to QII '83	12.4	13.3	-0.9	0.0	-0.9
QII '83 to QIV '83	7.2	5.5	1.7	0.7	1.0

COMPARISON OF REVISED AND OLD M2 GROWTH RATES
(percent changes at annual rates)

	Revised M2 (1)	Old M2 (2)	Difference (1-2) (3)	Difference due to Benchmark (4)	Difference due to Seasonals (5)
Monthly					
1982--Oct.	9.3	7.9	1.4	-0.1	1.5
Nov.	10.5	9.5	1.0	0.4	0.6
Dec.	12.1	8.9	3.2	0.5	2.7
1983--Jan.	31.9	30.9	1.0	-0.6	1.6
Feb.	21.7	24.4	-2.7	-0.9	-1.8
Mar.	7.8	11.2	-3.4	0.0	-3.4
Apr.	8.4	2.8	5.6	1.9	3.7
May	11.8	12.4	-0.6	0.1	-0.7
June	8.4	10.3	-2.0	-0.1	-1.9
July	5.4	6.8	-1.4	0.0	-1.4
Aug.	4.9	6.0	-1.1	0.0	-1.1
Sept.	7.1	4.8	2.3	0.6	1.7
Oct.	10.8	9.1	1.7	0.9	0.8
Nov.	8.2	7.2	1.0	0.0	1.0
Dec.	8.2	5.5	2.7	0.3	2.4
Quarterly					
1982--QIV	10.6	9.3	1.3	0.3	1.0
1983--QI	20.5	20.3	0.2	-0.2	0.4
QII	10.6	10.1	0.5	-0.5	0.0
QIII	6.9	7.8	-0.9	0.1	-1.0
QIV	8.5	7.0	1.5	0.4	1.1
Annual					
1982--QIV '82 to QIV '83	12.1	11.7	0.4	0.3	0.1
Feb/Mar. '83 to QIV '83	9.3	7.8	0.7	0.6	-0.1

COMPARISON OF REVISED AND OLD M3 GROWTH RATES[1]
(percent changes at annual rates)

	Revised M3 (1)	Old M3 (2)	Difference (1-2) (3)	Difference Due to Benchmark (4)	Difference Due to Seasonals (5)
Monthly					
1982--Oct.	11.7	9.3	2.4	0.0	2.4
Nov.	7.7	9.3	-1.6	-0.8	-0.8
Dec.	5.7	3.7	2.0	-0.3	2.3
1983--Jan.	14.4	13.0	1.4	-1.2	2.6
Feb.	13.1	13.7	-0.6	1.4	-2.0
Mar.	7.2	8.1	-0.9	1.2	-2.1
Apr.	8.7	3.3	5.4	2.8	2.6
May	9.6	10.9	-1.3	0.5	-1.8
June	10.3	11.0	-0.7	0.2	-0.9
July	5.1	5.5	-0.4	-0.2	-0.2
Aug.	6.1	8.8	-2.7	-0.3	-2.4
Sept.	8.8	7.6	1.2	-0.5	1.7
Oct.	9.4	8.6	0.8	-1.0	1.8
Nov.	14.1	11.9	2.2	2.7	-0.5
Dec.	8.8	6.6	2.2	0.3	1.9
Quarterly					
1982--QIV	10.0	9.5	0.5	-0.3	0.8
1983--QI	10.8	10.2	0.6	-0.1	0.7
QII	9.3	8.1	1.2	1.5	-0.3
QIII	7.4	8.4	-1.0	-0.1	-0.9
QIV	10.0	9.0	1.0	0.1	0.9
Annual					
1982--QIV '82 to QIV '83	9.7	9.2	0.5	0.5	0.0

1. Revised M3 includes term Eurodollars; the inclusion of term Eurodollars boosted M3 growth in 1983 by no more than 0.1 percentage points.

The CHAIRMAN. Thank you very much.

As I already mentioned, the Federal Reserve's target ranges for growth of M_1, M_2, and M_3 during 1984 are lower than the target ranges for 1983. Given the perspective of the Federal deficit that we both talked about, do you believe that tightening money to that extent will push interest rates up?

BUDGET CUTS COULD HAVE FAVORABLE CLIMATE ON ECONOMY

Mr. VOLCKER. These target ranges, which are one-half to 1 percent lower than last year, are calculated to be consistent with the kind of economic projection that we have. The projections, while they are a summary of the individual projections of different people, assume a budget deficit for 1984 of the overall magnitude that is reflected in the President's budget—slightly higher—and the President's budget assumes some action would be taken.

As I suggested, the implications for interest rates, in the first instance, really depend upon the degree of demand pressure on the economy. If the underlying demand pressures are stronger than assumed by this projection, I think the targets might imply a tendency for interest rates to rise, and that would be a restraining influence on economic growth. If, in contrast, as some people believe, the underlying demand pressures in the economy tend to be at a slower rate than this, interest rates should decline, and that decline in interest rates will buoy the economy, and tend to keep it on track.

I don't think the targets themselves should be looked at as an independent influence on interest rates. Too much depends upon what happens in the rest of the economy, and the budget, of course, is one factor in that. If the deficit turned out even worse, that's a factor pushing interest rates up; but if progress were made on the deficit, that would clearly be a factor pulling interest rates down.

The only other point I would add is that, in looking at budgetary action, I would assume that the markets have already discounted or expected the budgetary situation to be pretty much as it exists. If there can be really concrete progress and a sense of direction, even if the measures were not effective in any substantial amount during the course of calendar year 1984 the changed expectation could begin to have a favorable impact on the markets in 1984.

The CHAIRMAN. Obviously, we are already into 1984. What we are talking about is 1985 budget levels.

Mr. VOLCKER. Right.

The CHAIRMAN. So let me give you some figures and see how you would respond to some specifics. I certainly am hopeful that the administration and the Congress can get together on some sort of a budget reduction package; from my standpoint, hopefully more than a downpayment.

Let's assume that we could and that you had a $30 to $50 billion reduction in the deficit. Then what would your recommendations be, not only on your targets for monetary aggregates---

Mr. VOLCKER. $30 to $50 billion in 1985?

The CHAIRMAN. In the 1985 budget.

Mr. VOLCKER. From the current services budget?

The CHAIRMAN. From the budget reduction package. In other words, we can all talk in generalities, as we do, but just to pin it down more, if we had that kind of budget reduction in the 1985 budget—in others words, now we're talking about getting down to $120 or $150 billion, then what would the Fed's recommendations be?

Mr. VOLCKER. I have no doubt that if you got down to that budget area with some degree of assurance and that had the clear implication of continuing savings in future years beyond 1985, that that would have a favorable effect on the market climate and you should see some noticeable reactions, in my judgment, on interest rates—particularly longer term interest rates—even if the actual demands of 1984 are as projected.

I don't think, in the first instance, it should imply any change in our monetary targets. Within those monetary targets you would have a more favorable interest rate outlook and you would have a more favorable economic outlook, in the sense that you would have been laying the foundation for a more balanced and sustained recovery.

The implications would be totally favorable, but I don't see why they would necessarily change the monetary targets.

The CHAIRMAN. Why not? Usually the Fed's response, at least since I've been here, the bigger the budget deficits, we're the only ball game in town on inflation and therefore we're tightening up and trying to counteract. So if we're finally, assuming we did, going in the other direction, why wouldn't that imply that there wasn't as much pressure, as you just said, a much more rosy outlook if we did that and so on, then why wouldn't it also follow that there should be an easing?

Mr. VOLCKER. I don't think we've tightened up the targets in the past in response to budget deficits. These targets are set in terms of what seems appropriate for an overall end product of growth in the economy without inflation, the mixture of those two things.

What it does change is the market environment. It changes what people think of as ease or tightness of policy, measured by the way interest rates go. It may well have implications for the degree of reserve pressure, which influences interest rates in the short run; if you take out one source of demand pressure in the economy—and you're talking about taking it out in 1985 not in 1984—even prospectively, that might change the market climate. It should change the market climate as I've suggested; you're not changing the deficit at all in 1984, so the immediate demand pressures are the same. But even then, you might get a situation in the economy where to achieve these targets required less pressure on bank reserve positions which would be a good thing in terms of interest rate outlook. But that does not say that because you have a lower budget deficit you want to have a money supply increase that would be judged over time to be inflationary. That's the balance we have to find and, given your assumption, my first reaction would be that there would be no reason, for that reason alone, to change these monetary targets, which are set to achieve a balance between enough money to keep the economy going but not enough to refeed inflation, to the extent we can judge that balance.

The CHAIRMAN. I understand the balance you're trying to achieve. It's certainly not the deficit alone but the other factors, the more optimistic picture, it would seem to me then there would be less pressure.

Mr. VOLCKER. There would be less pressure on the markets.

The CHAIRMAN. Less pressure which would allow you to have somewhat higher—and I'm not picking figures of where that balance should be.

Mr. VOLCKER. In a technical sense that should lead us to let's say raise the targets if we thought something was going on that was leading even temporarily—I mean over a period of 1 year or so—or more permanently to a reduced rate of velocity growth. If the relationship between the growth in the economy as a whole and inflation is changing, we ought to change our targets; we make our best judgment on that. But it's not apparent to me that changing the deficit assumption would change that velocity assumption. If it did, then we ought to change the targets, but it's not apparent to me—certainly in the short term——

The CHAIRMAN. Well, I wish Congress would produce that for you and then we would see in actuality what would happen.

Mr. VOLCKER. Let me give you one hypothetical example, which I stretched out over a longer period of time. Suppose such progress were being made on the deficit that interest rates within this kind of framework moved very decisively lower. That might be a factor inducing people—particularly now that we pay interest on NOW accounts and supposing we were to pay interest on demand deposits—to hold more cash relative to economic activity than they have in the past. That would be reflected in a slowdown of velocity, and we ought to allow for it.

But I think that's hanging out some distance in the future as a possibility, rather than as a current matter of debate under the kind of assumptions you make. If you carried through that policy for a few years, and it may indeed be that velocity would change.

IMPLEMENTATION OF CONTEMPORANEOUS RESERVE ACCOUNTING

The CHAIRMAN. I'm going to change the subject to another one quickly before my time is up on this round.

Last week the Fed finally implemented the contemporaneous reserve accounting, a procedure that I have advocated and other members of this committee for a long, long time, which I believe should improve the Fed's control over the monetary aggregates, and I won't get into that whole discussion of the validity of weekly reporting and all of that,

But how do you feel contemporaneous reserve accounting will impact on bank behavior and how much will the switch from the lagged reserve accounting dampen the volatility of M_1?

Mr. VOLCKER. I have a very rather cautious and restrained approach toward that. I always have. I don't think it's going to make a big difference. But technically, if your objective is to exert close control over M_1 in the short run, there are advantages in the contemporaneous reserve accounting.

We have, for the time being, as reflected in our report, decided not to change our operating technique because of the introduction

of contemporaneous reserve accounting in an effort to achieve a very close control over M_1. We have not done so partly because we don't think that technique should drive policy and we have enough tentativeness about the relationships between M_1 and the rest of the economy and M_1 and the other aggregates that we don't want to, in effect, put all our money on controlling that particular aggregate tightly.

If we wanted to do that, then contemporaneous reserve accounting would be a help, and we will be evaluating that as time passes; it's basically a judgment as to whether the velocity of M_1 is returning to the degree of predictability and stability that's necessary to rely upon it that heavily. We see some signs in that direction, but they're still tentative, so we are going to continue to look at it.

On a more purely technical front, the change to contemporaneous reserve accounting and related changes in reporting inevitably, for a short-transitional period, introduce some uncertainty as to how banks themselves will react and how many excess reserves they want to hold--that is, how they will react in the money markets on a day-to-day basis, while they are adjusting to what is a factor of uncertainty for them. They no longer know their reserve requirement as the week progresses with the certainty that they did before, so that introduces some transitional questions. I don't think they will last very long, but nonetheless, we're right in the midst of those at the moment, and for that reason alone we would be quite cautious about putting a lot of weight on contemporaneous reserve accounting in order to achieve a given money supply objective during this transitional period.

We may have some problems in getting all money supply figures together with the degree of accuracy and speed that we like to achieve, simply because during this transitional period both the banks and Federal Reserve System have to adjust to a new reporting system.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator Proxmire.

Senator PROXMIRE. Chairman Volcker, some have argued that the Federal Reserve has historically tried to help the incumbent in the White House during a Presidential election year by easing monetary policy. There's one conspicuous exception to that. In October 1979, the new Chairman of the Federal Reserve Board instituted a policy of slowing down the rate of increase in the supply of money and I don't think anybody could argue that Paul Volcker was a big help to Jimmy Carter in 1980.

Do you have any understanding with the administration, explicit or tacit, that you will follow an accommodative policy in 1984?

Mr. VOLCKER. No, sir.

Senator PROXMIRE. Will you agree to report to this committee and to the House Banking Committee any instances of the administration bringing pressure on the Federal Reserve to relax its policies?

Mr. VOLCKER. I don't know what context you're thinking of exactly. I keep in close contact with administration officials and we discuss fiscal policies and we may occasionally discuss monetary policy. I don't interpret that as pressure, and I don't assume that you would interpret those continuing discussions as pressure.

Senator PROXMIRE. Well, what I'm talking about is if they talk to you privately as distinguished from any public statements they might make.

Mr. VOLCKER. For political purposes? I suppose that's the distinction.

Senator PROXMIRE. Well, as to political purposes, let us judge that. I mean, it's 1984. It's hard to find something that isn't political.

Mr. VOLCKER. I understand, but I don't want to make a commitment that every time I have a conversation with somebody in the administration that I have to report the nature of those conversations; we have continuing discussions, as I say, on various aspects of economic policy.

Senator PROXMIRE. Well, Chairman Volcker, you obviously weren't born yesterday. I think you know political pressure when you see it.

Mr. VOLCKER. That's right. That's why I make a distinction between a kind of continuing discussion, which I think is normal, and something one would interpret as part of an election campaign. I think I can tell the difference between those.

Senator PROXMIRE. Well, how about letting us in on it? Will you do that?

Mr. VOLCKER. If I can see the distinction.

Senator PROXMIRE. You can see the distinction.

Chairman Volcker, the February 1 budget of the President was sent to the Congress with economic projections that predicted that if we adopted the budget as set forth over the next 5 years we would have the following economic consequences: No. 1, steadily falling interest rates with the Treasury bill rate coming down from 9 to 5 percent by 1989; mortgage rates falling from about 12.5 to 7 percent; steadily falling unemployment with the unemployment rate declining to 5.5 percent in 1989; moderate inflation with the inflation rate staying close to 5 percent through 1989.

Now these OMB projections assume accommodative monetary policy. Could you recommend a monetary policy consistent with those objectives within the constraints of the budget that's being recommended?

OMB PROJECTIONS SHOW NOMINAL DECLINE IN GNP

Mr. VOLCKER. I don't have those projections in front of me, but they would imply, as I recall, some fairly steady declines in the overall nominal GNP and some declines in the inflation rate after 1984 or 1985. I think those projections would be broadly consistent with a reduced rate of growth of the various monetary aggregates through that period.

Obviously, in saying that, I'm assuming more or less historical patterns of velocity.

Senator PROXMIRE. Well, let me be more precise. If we adopt these budgets, do you think that there's any prospect that we could expect to have interest rates decline over the next 5 years? Is there any kind of monetary policy that could achieve that, in your view?

Mr. VOLCKER. Very clearly, those deficits work in the other direction. You get declines in interest rates if the economy is bad

enough, but that's not consistent with other parts of the projection. I agree with the thrust of what you're saying and I think those are highly optimistic projections in the context of no further action to deal with the budget deficit.

They do assume further actions to deal with the budget deficit. I do not consider those estimates out of the ballpark in any sense in the context of what I would see as the need for an improved budgetary picture and the actions to achieve that.

Senator PROXMIRE. In other words, if we had a different budget, a different deficit, then it's possible that we might get a decline in interest rates, but these deficits that are recommended, would you say that it's not possible or is that going too far?

Mr. VOLCKER. I think that may be going too far.

Senator PROXMIRE. This combination of falling unemployment and declining interest rates?

Mr. VOLCKER. With the inflation forecast that they have, I don't think that you can say it's impossible. The risks that we could be quite off course increase drastically unless some improvements are made in the budgetary picture.

They have assumed some improvements in the budgetary picture. I think there's a real question as to whether they have assumed enough in order to assure that kind of outlook.

Senator PROXMIRE. The President sent us a budget. It was his budget. He can do anything he wants to.

Mr. VOLCKER. But that budget included assumptions of some expenditure savings and, indeed, some revenue increases through new actions.

Senator PROXMIRE. But it had the net effect of a deficit that they projected at $180 billion in 1985.

Mr. VOLCKER. That is correct. The deficit would be even bigger if they didn't assume those actions.

Senator PROXMIRE. Exactly.

Mr. VOLCKER. We're operating from the baseline according to the budget ceiling.

Senator PROXMIRE. And you say that it's possible under those circumstances, even with that kind of a deficit, to have interest rates fall but only if you had less growth in which case you'd have increased unemployment; is that right?

Mr. VOLCKER. Certainly interest rates would fall under those assumptions. Those estimates are optimistic, in my judgment, because they don't allow for the risks and pressures arising out of the budget deficit. I don't think they would be unduly optimistic, certainly not on interest rates, with a different budgetary picture.

Senator PROXMIRE. I'm really surprised. In fact, I'm astounded. I would think that you would tell us that it is absolutely impossible with a $180 billion deficit in 1985, almost as high a deficit in 1986, almost as high a deficit in 1987, to find any kind of monetary policy that would give us a decline in interest rates over that period to 9 percent and 5 percent inflation. It doesn't make sense.

Mr. VOLCKER. What they're assuming is that the inflation rate will rise in 1985.

Senator PROXMIRE. Well, slightly.

Mr. VOLCKER. Slightly, and then begin declining and get down to 7.5 percent. If you make that assumption, I think that is the kind of environment in which interest rates would be lower.

Senator PROXMIRE. Can you make that kind of assumption with deficits of that size?

Mr. VOLCKER. There is considerable doubt about our ability to meet those kinds of projections—to put it mildly—under the current kind of budgetary projections. But, putting it positively, if we took action—let's say along the lines that Senator Garn is suggesting, with a followthrough in subsequent years so that that deficit is knocked down further—then this terrible picture that we have before us of deficits compounding upon themselves and keeping interest rates up and leading to the $300 billion deficit that the CBO outlined yesterday—need not materialize. If you could get the budget deficit down, keep inflation under control, interest rates will in fact begin coming down in that climate. Then your future budget deficits out there in 1988, 1989 and 1990 reflect the favorable effects of lower interest rates than anticipated, and lo and behold you find the budget deficit decreasing more rapidly than you expected. But you've got to get the process started.

It can either explode on you or it can gain momentum in a favorable direction. Whether it explodes or builds in a favorable direction depends upon how quickly and how forcefully you take some action, in my opinion.

NEED TO IMPROVE HORRENDOUS TRADE IMBALANCE

Senator PROXMIRE. I want very much to agree with you and I believe very deeply in you as Federal Reserve Board Chairman, as you know, but I think there's a momentum here that all of us are caught up in and I just wonder if we shouldn't be a little more cautious.

Let me put the question this way. As an economist, would you expect that the increase in the Federal deficit in the past 2 years during which it rose about $58 billion in 1981 to $109 billion in 1982 and to $195 billion in 1983 played any part in stimulating the economy? And if it did, would not a sharp reduction in the deficit, lowering it by say $60 or $70 billion a year, cause a slowdown in the rate of recovery?

Mr. VOLCKER. I don't think we're going to get a cut that big.

Senator PROXMIRE. Well, say a $50 billion reduction.

Mr. VOLCKER. We're not going to get $50 billion in a year as a practical matter. But the impact of that would be, yes, to take some purchasing power out of the economy and presumably, in the first instance, to slow consumption.

I think the effects of that on financial markets, the climate for investment, the interest-rate level, would quickly produce forces in the economy that would yield offsetting expansion, and you would end up with a far better balanced picture than what you have now.

Senator PROXMIRE. Have you got any kind of a model you can put this into to determine whether or not you would be able to get that.

Mr. VOLCKER. You can put it in a very standard model.

Senator PROXMIRE. Have you done that?

Mr. VOLCKER. Our economists run these models all the time. I'm suspicious of these models, but——

Senator PROXMIRE. So am I, but it just seems to me——

Mr. VOLCKER. They never take care of the unexpected, but the general direction is precisely as I've described it. What would you end up with? You would end up with relatively less consumption. You would end up with more investment, more capacity, more productivity. You would certainly end up with more housing and you would end up with an improving trade position instead of a deteriorating trade position.

The major point of imbalance in the economy right now is that horrendous and growing trade deficit. That's the pressure. It's coming out on housing and investment; it's implicit in the high interest rates. But where you actually see the forces of the economy knocked on the head, so to speak, in a clear cut way is in the trade sector, and that is the place where you would expect to get improvement.

All those adjustments in the model take time. On the other hand, a model does not reflect, in my judgment, the real risks that we are running in the economy now by keeping the deficit high. What do those models show? They show the opposite of what I just said. They show high consumption, low investment, deteriorating trade picture, low housing, higher interest rates than you would otherwise get, and bad growth over a period of time, but it doesn't look like any great crisis.

Models never predict a crisis. They don't allow for instability in exchange rates and fears about the dollar. They don't allow for the pressures on the thrift industry. There's nothing in those models that talks about the presures on the international financial system growing out of international indebtedness and the pressures that high interest rates put on Mexico, Brazil, Argentina, Chile, and Venezuela and so on, and the risks that poses to the banking system. They're not in a model, but they're in the real world, and those are the risks that we are running of adverse financial and therefore economic consequences. They aren't reflected in these models, but those are the risks I'm worried about, together with the problems that are reflected in the model.

Senator PROXMIRE. My time is up.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

I agree with the chairman of the committee when he said the reason why Congress talks about monetary policy is because they don't have anything to do with it. Now, I've noticed a lot of your comments since you've been coming before us for the last 3 years about Federal spending and the different sides of the economic equation. Maybe you ought to be chairman of the Council of Economic Advisers. I'm saying that as a plus to you.

But no matter how many times you come down here and testify, I'm not sure whether anybody is listening to you, especially about the need to reduce Federal spending. We in Congress keep talking about monetary policy, but we keep ignoring the fiscal side of the economic equation. You do it in a more eloquent way than the way I do in labeling this place as a "big, fat cow." That's what the budget is, and it needs further restraint. We can't ignore that.

When Congress passed TEFRA in 1982, there was a decline in the Fed's funds rates and an expansion of the money supply, as I recall. Now recognizing the current restrictive stance that the Fed has taken with respect to the expansion of the money supply, is the Fed trying to tell the Congress to pass TEFRA II? In other words, are you requesting a downpayment before the Fed expands credit?

Mr. VOLCKER. I'm certainly advising you to take whatever steps you can take to reduce the budget deficit. But if you are suggesting that we are following some policy with respect to credit or monetary expansion that is different from what we would otherwise follow, that we are tighter than we otherwise would be, to make a political impression on the Congress, that's entirely wrong.

PRESIDENTIAL LINE ITEM VETO POWER

Senator MATTINGLY. All right. You and I have talked before, and it's no big secret in this room that this place spends too much money. All I'm asking is if we reduce the spending, and thus the deficit, interest rates will start declining?

Mr. VOLCKER. If you make the kind of move that the chairman talked about, I think you will see the results in interest rates.

Senator MATTINGLY. You're talking about the $100 billion downpayment?

Mr. VOLCKER. I was thinking of his $30 to $50 billion in 1985.

Senator MATTINGLY. OK. Well, even if we achieve the $100 billion downpayment, that's sort of a patch.

Mr. VOLCKER. I think that's the first step.

Senator MATTINGLY. Let me just give you a couple of proposals so we can get your input.

Do you think that we ought to try to grant a line-item veto for the President?

Mr. VOLCKER. Obviously you're getting out of my technical expertise.

Senator MATTINGLY. No, I'm not. I'm only trying to control the budget.

Mr. VOLCKER. It's a big political issue. I have expressed earlier in testifying on the balanced budget amendment, that I thought the Congress ought to look at something like a line-item veto. If there is a bias toward spending, which seems to be apparent, that's one way to approach it and it seems to me appropriate constitutionally.

Senator MATTINGLY. Well, in other words, we need to enact it right away so it will have some impact. By going the Constitution route, which both Senator Dixon and I would like to see happen, it would take a lot longer to do it. We, therefore, should approach it by a statute so we can get it done right away, even though it will potentially only impact 15 or 17 percent of the budget.

Mr. VOLCKER. Then that's your judgment. I'm generally sympathetic toward a line-item veto. I don't think it's going to revolutionize the budgetary picture in the short run, precisely for the reason you suggested.

Senator MATTINGLY. OK, Senator Dixon, that's one more on our side.

Now, if we have the $100 billion downpayment, and what it may be composed of can be looked at later——

Mr. VOLCKER. It's a question of what it's from, too.

Senator MATTINGLY. That's right. In order to really have the fundamental reform that's necessary to get through this—you know, everybody is looking for 1985 and the election year cycle—but what do you think about establishing some type of a spending reform commission to look at just strictly the spending side of the budget. Not taxes because we've already got Secretary Regan looking at the issue of tax reform for the tax side; but just a spending reform commission? In other words, do you think this would help, in your viewpoint, if you knew we were going to enact some type of $100 billion reduction over the next 3 years and at the same time that we were going to establish a spending reform commission so we can really get into the spending side of the budget.

Mr. VOLCKER. If you're asking me for a technical judgment as to how the market would react to that, I would be surprised to see much of any reaction. I think they are cynical, or jaded, or whatever. We have a spending reform commission, in effect, in the Grace Commission.

Senator MATTINGLY. Now what I'm talking about is a group to go out and put together a package of reforms, taking into consideration all programs, even the 1984 index programs in the Federal budget——

Mr. VOLCKER. What kind of reporting date?

Senator MATTINGLY. Say a year would be fine. I'm just saying that they need to get to work in order to come up with a total package, one that makes substantive spending reforms.

Mr. VOLCKER. Let me say, first of all, I would think it would be terribly important that that kind of thing not be used as an excuse for not carrying through in the short run.

Senator MATTINGLY. That's what I said. I'm saying that we go ahead and begin consideration of fundamental spending reform now.

Mr. VOLCKER. I understand you said that. I just want to reiterate that I think it would be counterproductive if it were interpreted as a substitute.

Senator MATTINGLY. I think if we passed TEFRA II, or whatever you want to call it and even the $100 billion package, you'll be back here next year saying the same thing and the year after because we will not have approached the fundamental cause of what's wrong with the Federal budget.

Mr. VOLCKER. Right. That's one way of approaching it, with a close enough deadline, if it's your political judgment that the way to approach some of these tough positions is to get further enlightenment. Maybe it's helpful, but I do not feel that you should count on a lot of market reaction to it.

Senator MATTINGLY. Well, I'm not really looking at the market reaction so much as I'm trying——

Mr. VOLCKER. I'm talking about interest rate reaction. I would not oppose that. I have no reason to oppose it. I think it is basically a political judgment as to whether that's an effective key to unlock these very difficult decisions; you would have a better judgment on that than I would.

Senator MATTINGLY. Well, you've been up here in Washington longer than I have and you see what the Congress does. They get

sort of in a box and they pass little things like dairy bills and everything else that locks you into more Federal spending as time goes on. All I'm saying is I think that we can make the minor restraints in the budget, but in order to get fundamental reforms, we have to have a different approach or we need to do the same thing next year and the year after that.

Mr. VOLCKER. I agree completely. It's just a question of how you get there.

COUNTRY NEEDS TO OVERCOME TRADE DEFICIT

Senator MATTINGLY. One last comment. I was glad to see you really begin talking about the trade issue. I think Senator Heinz will agree with me, you know, we talk about monetary policy, fiscal policy, and defense policy in this country, but we have not driven the issue of trade policy up to the level that it should be. And I'm glad to see that you bring this issue up to that level. You and I both know that our trade deficit is not all due to the overevaluation of the dollar.

I know this may be a little bit out of your ballpark, but what would you consider helpful in expansion of trade, other than reduction of the overvalued dollar?

Mr. VOLCKER. I think, as always, there's a lot of work to be done in terms of opening other markets fairly to our goods, and that requires more force in some countries than in others. But in a very practical way, I suppose the greatest challenge now is to prevent closing, rather than to open; we have been guilty of some of that ourselves. I think we are in a very dangerous area of retreat on the side of opening of markets here and abroad, and that that will rebound to our disadvantage over time unless we can correct the bias.

I do think a lot of the fundamental difficulties come out of two things. It's partly interest rates or the mix of policies here. Also, the fact is, we've been growing more rapidly than other countries. In the short run that's fine. It has affected our trade position adversely, but we hope it's corrected by more growth abroad. But the mix of policies, the budgetary situation, the level of interest rates that emerges out of that has a very pervasive and fundamental influence on our trade patterns in an adverse way.

This is the principal manifestation right now of the tensions we have in the domestic economic policy.

Senator MATTINGLY. But as we notice now the projections for the foreign trade deficit is being pushed another $30 billion.

Mr. VOLCKER. Sure.

Senator MATTINGLY. Now in order to help our people here at home, outside of trying to make understandable laws that they can go by, do you think there ought to be greater consideration of barter?

Mr. VOLCKER. Of barter, no.

Senator MATTINGLY. Why?

Mr. VOLCKER. Basically, over time, that goes in the wrong direction. I think we are going to be best off in trade with relatively open markets, freely competitive situations. There may be very specific instances where barter is useful, but moving the system

toward barter implies to me, in the end, a lot less trade. I suspect, in the sheerest sense of self-survival and maneuverability, we are not very well equipped for that as compared to some other countries that are more used to barter and have more centralized economies.

I think we have to have an international trading system that fits with our perception of the way the economy works, which is open and competitive. I suspect if we ended up with a barter system we would get out-bartered pretty consistently.

Senator MATTINGLY. I'd like to pursue that, but my time has expired. Thank you.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, my distinguished friend from Tennessee has some serious time constraints. I wonder if I could step back one from him and accommodate him?

The CHAIRMAN. It's your choice.

Senator SASSER. Mr. Chairman, I want to express my appreciation to Senator Dixon for allowing me to go first this morning.

Mr. Chairman, there's a lot of talk about doing something about the budget deficit and indeed something has to be done about it. It's not easy for a politician to advocate a tax increase and a reduction in defense spending, but I think it's clear to anybody who's studied the situation that if we are going to have a meaningful reduction of the deficit, a tax increase and a reduction in defense spending are going to have to be part of the overall mix to bring that deficit down.

Now before the American public is going to accept either measure, they're going to have to be absolutely certain that it's necessary and, in my opinion, the President of the United States has given us absolutely no help in this regard.

The American people need to hear a clear and unequivocal message from public servants whom they trust that indeed we are going to have increased revenue, that indeed we are going to have to have some curtailment of defense spending, and there's where you come in, Mr. Chairman. You've got some credibility there with the people out in the country.

Given the current political and economic situation and taking into account the cuts that have already been made in nonmilitary spending, means-tested entitlements, social security, are you prepared to say unequivocally that tax increases ought to be enacted? Are you prepared to say unequivocally that reduction in defense spending will hold the administration's budget as needed?

Now if you're not prepared to be forthright and unequivocal about these matters, how in the world can you expect the American public to be persuaded that they are needed? If you decline to be forthright about the economic and budget situation that we face and to support those of us in the Congress who are trying to do something about it, how can you come here and ask for our support for a continued tight money, high interest rate policy that we appear to be embarking upon again?

Mr. VOLCKER. Let me make several comments. I will be forthright and unequivocal: I think that this country needs a reduction in those budget deficits; there are simply too many risks involved

in delaying action on that score, and you need action in a sizable way as a first step toward still more sizable reductions over time.

REDUCE DEFENSE SPENDING AND INCREASE REVENUES

Senator SASSER. But aren't increasing revenues and cutting defense spending vital ingredients in getting this deficit under control?

Mr. VOLCKER. Let me simply say all I can say on that subject. In my judgment, you've got to make a sizable dent on the deficit, in political terms at least. It's not all that huge in terms of total spending, but nonetheless, it is difficult. I can't tell you and it's not appropriate for me to tell you in what areas to make those cuts or how to increase revenues.

I do have a judgment, as a general observer that reductions of the size necessary are going to have to deal with many aspects of the spending side of the budget. If you can't do it on the spending side, you've got to do it on the revenue side, and I've listened to enough talks that I suspect you can't do it all on the expenditure side. You've got to find some combination touching on all those areas of which you speak, that produces that deficit. But I can't tell you how much has to be in any particular area or whether, unambiguously, any or every particular area has to be touched. My sense certainly is that it's got to be a broad attack on the problem.

Senator SASSER. But we all need to get together and address this thing. You know, it's not the Congress role to write the budget either. The President of the United States normally does that and has done it in prior administrations, but in this crisis year I think everybody is being asked to assume roles that they're not accustomed to, primarily because the No. 1 one actor has left the stage—or it might be more appropriate to say he's left the set—and I, for one, am not optimistic that anything is going to be done about the deficit this year. And you've indicated that the markets have already discounted the budget situation as it presently is and I think the market has accurately discounted it.

This bipartisan commission, in my judgment, is not going to make a significant contribution in doing something about the budget deficit. We are going to end up with some finger pointing. It's clearly a political ploy, in my judgment. And what we need here is some leadership to try to do something about this deficit. And what I hear people saying, coming before other committees that I'm on or appearing on the Sunday afternoon talk shows, is that nothing can be done about this deficit until after the election, until 1985, and you come here and tell us that something has got to be done now—and I think you're absolutely right about that. I think something has to be done or we're going to be in very, very serious difficulties and I don't see any way out of it. Perhaps others do.

But, Mr. Chairman, we need some leadership here and we need to have voices heard speaking with precision that are respected in the financial community and on Main Street in this country.

Mr. VOLCKER. I will speak with as much precision as I can, but I don't think I can tell you how to make those political judgments that are involved or which sector of the budget should be dealt with specifically.

Let me just make one further comment about your comment. You referred, I think, to a high interest rate or tight money policy. I don't interpret it as a high interest and tight money policy. I interpret it as a high interest result, given the conditions of the economy and given the conditions of the budget. I would like to see interest rates lower, the question is how to get them lower. I don't see any way, by some manipulation of monetary policy alone, to do that. I think that is perhaps the most important reason I can give you as to why we are so utterly dependent upon prompt budgetary action to unlock what was referred to yesterday as a gridlock on interest rates.

Senator SASSER. So we agree it must be prompt action.

Mr. VOLCKER. Yes.

Senator SASSER. And it cannot be postponed until after the election?

Mr. VOLCKER. I agree with that fully.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Chairman, last week in the Wall Street Journal—I just want to read one line—"Dow Chemical fourth quarter operating profits surged 362 percent." In this morning's Washington Post, "General Motors earnings quadrupled the company's 1982 income," and it went on to say, "The fourth quarter was eight times 1982 fourth quarter profits."

How come you never brought out the revenue side on reducing the deficit? You never speak about the revenues coming in.

HEFTY CORPORATE PROFITS ANTICIPATED

Mr. VOLCKER. I don't mean not to speak of the revenues coming in. I think the problem we have, Senator, is precisely that with rapid economic growth, with a good increase in profits, there is no prospect that those revenue increases, which are in response to economic growth, are going to be sufficient to narrow the deficit over time.

That is a measure of how difficult this budgetary problem is. The underlying deficit—if we standardize the deficit for the state of the business cycle and we allow for full employment—is still very large and it's getting worse; that is the budgetary problem. It's nice to have revenue growth, but we're not going to close the gap, in my judgment, by that alone.

Senator HECHT. How can you just say that? I mean, did you anticipate these type of profits 6 months ago?

Mr. VOLCKER. The economy has grown more rapidly than we expected, so the profit picture has done better than we expected. The profit picture has been better than we expected, and we picked up all those extra revenues, and you assume some more cuts in the President's budget, but you're left with a $180 billion deficit. That is precisely the problem.

Senator HECHT. Just a minute. We don't know what the profit side of revenues are going to be until after April 15 when the tax returns come in.

Mr. VOLCKER. We don't know, but we've got some projections, and that's been allowed for. Those profits, Senator, and tax receipts, have been allowed for in the administration estimates and other estimates.

Senator HECHT. What are the estimates?

Mr. VOLCKER. They are already there.

Senator HECHT. I'm just pointing out that when you have a company like General Motors making many times more in the fourth quarter over the year previous, who can anticipate anything like that?

Mr. VOLCKER. I think, in general, the profits picture was anticipated. I don't know about precise levels for Dow Chemical and General Motors, but there are estimates of corporate profits. We've all assumed that corporate profits in 1983 were sharply higher, as indeed they were. We expect further improvement in 1984. Yet you are still left with those deficits.

In fact, corporate profits taxes as a percentage of tax receipts has been declining because those reflect in part some of the measures that were enacted by the Congress earlier to relieve corporate profits taxes. So, you've got an inflow from higher profits, and you've got loss of revenues from tax laws that are already on the books. All of that is taken into account in these deficit projections.

Senator HECHT. On what basis do you anticipate revenue or what percentage do you anticipate on the deficit projections coming in?

Mr. VOLCKER. I haven't got that figure right in front of me. I would be glad to provide that to you, but I know in our own internal projections we allowed for a large increase in corporate profits, and I have no reason to believe that is widely off the mark. In fact, we have preliminary data for 1983—which could be changed—but to the extent we have data it's already been allowed for. It's not just us. The Treasury has certainly allowed for it in their new estimate. There seem to be others who certainly allow for it in theirs. I don't have the absolute number here, but corporate income taxes are right now, because of cyclical factors, estimated to increase the estimate I have here—this is the administration estimate—is that profits would go up 10 percent as a whole, from only 6.2 percent last year. That reflects that profit growth you're talking about.

You get a kind of one-time boost in corporate profit tax receipts reflecting the speed of recovery. My major point is it's already been allowed for; it is in those estimates.

Senator HECHT. Of course, I'm questioning the estimates.

Mr. VOLCKER. Profits could be higher than what has been estimated; that's obviously a possibility if the economy continues to grow, but I would suspect the difference between the increase already estimated and what may materialize may account for a few billion dollars. It's not going to be terribly significant in the context of the overall budgetary picture.

Total corporate profit tax receipts these days must run about $60 billion or something like that a year. If you had a 10-percent miss in the estimate, which would be large, you would have another $6 billion; that's not going to revolutionize the budget picture.

Senator HECHT. But if we dropped unemployment down, these people are paying into the Treasury.

Mr. VOLCKER. The faster the economy grows, all else being equal, the better the budget picture would look in the short run. But what I come back to is the point that even if you magically assume full employment and the level of profits that goes along with that, you would still be left with a large and growing deficit. And, if you magically assume full employment, you also must be assuming a high level of investment. Where are the savings going to come from to finance that high level of investment at full employment if the Government is still running a deficit?

Let me put it another way. We don't have a $200 billion problem in my judgment, for the very kinds of reasons that you're suggesting. But we have a $100 billion-plus problem and it's getting worse. Take away $100 billion of the deficit and ascribe it to growth. We still have got $100 billion left and it's getting worse.

Senator HECHT. Of course, I'm questioning that it's getting worse when I see the fourth quarter earnings coming in and I still feel you're not taking into account the revenue that could come in. I've spoken to business people in my own State and around the country and not one did not have a better year in 1983 than 1982—not one. Everyone has hired more people. More people are working.

Mr. VOLCKER. I have one set of estimates that shows a steady increase in corporate profit tax receipts. There was a large increase in 1983—this is on the national income accounts basis—from $48.5 billion at an annual rate in the first quarter to $62 billion at an annual rate in the fourth quarter. That is allowing for the profits increase you're talking about. It's a big increase in 1 year—$14 billion, about 25 percent or a little more than 25 percent over the course of the year.

Another 10 percent increase is expected based on these projections over the course of the next four quarters. That is already in these estimates.

Senator HECHT. It's been said by different people running for President that a 1-percent drop in unemployment cuts $30 billion off the deficit. Is this a true figure?

Mr. VOLCKER. In the short run, that is right. And that is why I say if you imagine that we were suddenly at 6- or 7-percent unemployment, you would have a budget deficit that was, say, $60 billion less. I agree with that.

What troubles me is, yes, it would be $60 billion less, but it would still be $120 billion, and it's that $120 billion that I'm worried about.

Senator HECHT. Of course, I like to reserve all my analysis until the revenues start coming in in April because I still don't—I feel you have underestimated the revenues, forgetting the corporate profits which are very important which you have agreed to, the individual businesses and the people working ——

Mr. VOLCKER. They're not my estimates. They're the administration's estimates. I don't say that in disparagement in any sense; they make the best estimates they can I'm sure, but they certainly have allowed for the increase in corporate profits and they may well be understated—that's always possible—but they're not going to be understated by enough to fundamentally change the budget outlook.

Senator HECHT. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Senator Dixon is next.

Senator DIXON. I don't mind.

The CHAIRMAN. Well, we shifted with Sasser and I'm trying to be fair to you, however you want to do it. You were here before Senator Sasser.

SAVINGS RECOMMENDATIONS NEEDED

Senator RIEGLE. I appreciate your courtesy. I think Senator Dixon was here before me and should go next.

Senator DIXON. You're very kind. I thank my friend from Michigan. I appreciate that.

Mr. Chairman, I've seen you in the ring a long time. I've never really seen anybody lay a glove on you, so I'm not going to try to do that, but I would like to ask you one general question and then offer what I hope might be three specific positive things to take under consideration and see what you think about them.

In the first place, I've heard everything you said early on about demand in the marketplace and the uncertainty of it with respect to predicting what interest rates would do, but would it not be true that most reasonably prudent people would feel that if this Congress passes the $925 billion budget that the President has asked for and if you adhere strictly to the monetary growth policy that you've indicated to this committee at slightly less than the monetary growth rates in 1983, that interest rates will almost certainly rise?

Mr. VOLCKER. I think they almost certainly will rise in the sense of reporting——

Senator DIXON. In the sense of what?

Mr. VOLCKER. In the sense they report what people's attitudes are, as I understand it.

Senator DIXON. Well, wouldn't it really be what you expect, Mr. Chairman, if we pass a $925 billion budget with an 18-percent increase in defense, an increase of $48 billion, and you stick to the monetary growth rate lower than last year that you have indicated to the chairman of this committee, wouldn't you personally expect interest rates to rise?

Mr. VOLCKER. I would anticipate that you couldn't count on that not happening. [Laughter.]

Senator DIXON. That's the closest anybody ever got to you, my friend.

Well, let me talk about three things with you. I would be very interested—and I respect your judgment very much. I want you to know that. I want to talk about three specifics.

Mr. VOLCKER. I would just repeat what I said before.

Senator DIXON. As an old trial lawyer once I've had that, that's all I want.

Let me try three things on you for size. My friend from Georgia talked about the line-item reduction veto power of the President. I enthusiastically support that. I have on file in the Senate down now, laid down Senate Joint Resolution 26 which would give this power to the President. Now, 43 of the 50 Governors have it. Mr. Chairman, in my own State of Illinois, experience last year trans-

lated to the Federal budget, we could save between $15 and $20 billion in this budget by giving the line-item reduction veto power to the President of the United States, and I ask you whether that would be good news to the money markets, Wall Street, and the stock markets?

Mr. VOLCKER. That kind of reduction would be. I don't think the reduction is enough.

Senator DIXON. I understand that now. All right. Now the President has asked for a bipartisan commission. The greatest laugh we had in the state of the Union address was when he suggested they report back in December after the election. I'll ask you this question.

If some kind of a bipartisan commission would look at this problem and make some solid recommendations to the Congress by let's say June of this year, this being February 8, some solid recommendations on savings, on some specific revenue enhancement taxes, and some savings in this budget that would save substantial billions of dollars so we all had to really belly up to the bar and do something significant before this year is finished, would that be good news to the money markets, to Wall Street, and the stock markets?

Mr. VOLCKER. As a substitute for this current effort?

Senator DIXON. Well, this current effort if they report back in time so we can do something this year before the session is over.

Mr. VOLCKER. My sense is that this current effort, while it's much more informal than what you're proposing, is what is on the table, so to speak. I believe the administration people have said that everything is on the table and it seems to me the practical thing is to seize upon that initiative and do exactly what you're talking about.

Senator DIXON. Good. Now let me pursue that without any regard to where you cut because there are places you could cut I'm sure in domestic and in defense spending, but let's just a moment talk about defense spending that my friend from Tennessee referred to.

In requesting this budget for $313 billion for defense, up over the $265 billion request last year by $48 billion, an increase of 18 percent, 13 percent in real terms.

Now the last bill we passed was five, so I'll ask you——

Mr. VOLCKER. That's authorization.

Senator DIXON. All right, authorization. If we could save $20 billion in that area, that's good news, is it not, for the money markets, Wall Street, and the stock markets?

Mr. VOLCKER. Yes. I don't know when you use an authorization figure—just to illustrate how difficult this all is—how quickly that gets translated into lower levels of spending.

Senator DIXON. Well, then let's relate it to lower levels of spending. If the spending growth is 13 percent in real terms and I'm advised that it is, and for instance last year the House authorized 4 and we authorized 6 and we conferenced 5 and we got 5 as related to 13 this year, a savings there of a very substantial amount would be dramatic and noticeable, would it not?

Mr. VOLCKER. Yes, as part of a package, it would be important, but I'm not commenting on all the other elements that go into the spending package.

Senator DIXON. I understand that. Let me pursue it with one more thing. There's a pending bill in the Senate by Senator Danforth, a distinguished Member who's a Republican from Missouri, Senator Boren, a distinguished Member who's a Democrat from Oklahoma. Some of us refer to it euphemistically as the 3-percent solution, in which they suggest, when indexing goes in in 1985—I voted for indexing and many here did—it would go in at 3 percent less than the inflationary experience and the COLA's would rise at 3-percent less for a marriage of 6 percent.

Now I don't know what that translates to in dollars. I knew at one time frankly but I've forgotten. But that would be good news, would it not, for the money markets, Wall Street, and the stock markets?

Mr. VOLCKER. Yes. It seems what you're telling me, Senator, which I fully agree with, is you ought to be able to get together and take a variety of these measures and make the substantial impact that's necessary, and I would encourage you to do so.

Senator DIXON. I understand that and all I'm suggesting to you is if it is really doable this year in a real sense, many of these things, if distinguished leaders in the Government like yourself and others will continue to call as well as you have the last several days for that—and I congratulate you for the headlines you're getting. People say don't pay attention, but you're in large black print here and we would like to be back in black ink and I would simply suggest that if you continue to carry this message to the country it would help in connection with the national debate that's taking place right now in the Congress.

Mr. VOLCKER. I'll try.

The CHAIRMAN. Before I turn to Senator Heinz, if I could make one small technical correction. I would agree that the suggestion we wait until December was in error. The President should not wait. But that only applies to Secretary Regan analyzing tax loopholes and recommendations there. The bipartisan commission that was recommended of Congressmen and Senators is meeting and the intent was for them to make some recommendations as soon as they could for this budget process. So it was only from the tax loophole standpoint, but I would still agree with your comment. It was a laugh. Why December? Why not June? Why not July?

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

HOPE FOR BIPARTISAN COMPROMISE

Mr. Volcker, we have accomplished a great deal in the last 2 or 3 days of having you testify on the House side and here, having the administration up, and having our colleagues on both sides of the aisle speak. We've agreed that the deficit is bad. We've agreed that there are terrible consequences for trade, for investment, for the recovery that can flow from it. We have agreed that action needs to be taken. That's the good news.

The fact is, however, that in terms of an action plan we don't have one. The President's budget is a retreat from last year's budget when it comes to dealing with the deficit. We hold out the olive branch of a bipartisan compromise, but I note that if you take the President's proposed $73 billion in deficit closure over 3 years in his present budget and the hoped for $100 billion over 2 years that if we're fortunate—indeed, one might say extremely fortunate—might materialize out of a compromise downpayment bipartisan plan, we will have over 3 years reduced the budget deficit $173 billion to the tune of $55 to $60 billion. I seem to recollect that the last time the members of the Finance Committee tried to do that last year we were told by everybody to go away and forget it because it couldn't be done.

The President himself has said that there are a lot of things that he doesn't want to do this year. It's an election year. When asked whether we should attempt any restructuring of the entitlement programs for which we should all read retirement program, such as social security, Federal retirement, military retirement, the answer is, well, we really did that last year and it's off limits.

Now I don't want to be the skunk at the garden party, but it seems to me there's no party, and there's not a lot of leadership. And if our experience in this body is anything to go by, before there's going to be leadership or compromise there's going to have to be a crisis. That's what caused us to tackle social security 2 years ago. We barely made it, but we did make it and we got a solution. And this I think leads directly back to you.

We will have a crisis in this country if, and only if, the Federal Reserve maintains its second half of last year policy of making sure the money supply grows at a steady and slow rate. We will avoid a crisis in this country if when push comes to shove in the credit markets as the Government borrows more money the Federal Reserve eases credit, however imperceptibly and however obscurely.

And my question is, are you prepared to help bring about the necessary crisis through your continued restrictive monetary policy so that we deal with the deficit?

I hear one of my colleagues chuckling and I agree with him. It would be funny if it weren't true.

Senator RIEGLE. We're not all chuckling, I might say.

Senator HEINZ. While there may be a humorous overtone to that question, you've been in Washington long enough to know that when it comes to getting Congress to bite the tough bullets—in this case, spending—and when it comes to getting the President to bite for him a tough issue—taxes—there's going to have to be a critical reason for the two aforementioned players to do it. And you're the only person by following a restrictive, noninflationary monetary policy who can create that crisis.

My question then again is, are you prepared through thick or thin to continue to pursue tight monetary policies?

Senator GORTON. Senator, could I interject?

Senator HEINZ. I don't know. I was hoping for an answer from Mr. Volcker rather than from you.

Senator GORTON. I simply would like to add to the question, is it not the view of the Chairman that if he should go to a much less

restrictive monetary policy we would have the crisis all right, but it would just be a different one?

Mr. VOLCKER. You gave him part of the answer, but let me say, as a matter of general philosophical approach—and I feel very strongly about this—it is not our job to artificially provoke a crisis. We are not going to go out there and conduct a tight-money policy for the sake of trying to bring leverage on the Congress or the administration.

Senator HEINZ. Mr. Chairman, I never intimated that that was a part of your thinking.

Mr. VOLCKER. I wasn't absolutely positive about that.

Senator HEINZ. It might be an inevitable consequence.

Mr. VOLCKER. All right. I just wanted to make that absolutely clear because we would not touch that with the proverbial 10-foot pole.

What we do feel very strongly about and what I feel very strongly about, is that whatever shape that budget deficit is in—and for some reasons this becomes more imperative if the budget deficit is feeding inflationary expectations—that we adhere to a policy that we think is in the best long-term interests of the country to avoid a resurgence of inflationary pressures.

There's no doubt that that produces the risk that the pressures on the money market, which are already evident, would continue, and creates at least a risk that they could get worse depending upon a lot of other things that happen. It doesn't necessarily mean that, but that risk is inherent in the situation. That is what I'm warning about.

The final point I would make is the point Senator Gorton already made——

Senator HEINZ. Well, he gets his time later.

Mr. VOLCKER. I was going to give you this answer, that some kind of an attempt to, as you put it, head off crisis by increasing the money supply in a way that's interpreted as inflationary is not going to put it off very long. It will produce pressures in maybe a slightly different form, maybe slightly later, maybe not.

Senator HEINZ. I have no quarrel with Senator Gorton's question or the implicit answer to it that you get a different kind of problem which is just as bad.

EFFECTS OF THE INFLOW OF FOREIGN CAPITAL

Mr. VOLCKER. The aspect of that that I would just want to amplify is that we are dependent now, and increasingly dependent, upon this inflow of foreign capital. That's there for a variety of reasons, including relatively high interest rates, including uncertainties abroad, political and economic. I would like to think it's partly there because of some sense of relative confidence in our economic policies.

If the Federal Reserve is interpreted as following irresponsible policies, we face a potential for a bigger disturbance, to use a polite word, on the international side simply because of the enormous vulnerability that we have permitted ourselves to build up over a period of time.

Senator HEINZ. Let's talk about that because you raise a good point. Two percent on an annual basis of our gross national product is being supplied by foreign credit. You mentioned that in your opening statement.

Mr. VOLCKER. That's still a projection, but it's a pretty good projection.

Senator HEINZ. Not a bad projection. Were the money supply to include—and it does not—but were the money supply to measure let's say in M_2 include the importation of foreign funds instead of growing at 7.5 percent or whatever it was M_2 grew at, what would that equivalent be?

Mr. VOLCKER. It depends upon the form that the inflow takes; some of it might be in M_2 or M_3.

Senator HEINZ. I'm just trying to get—I'm not trying to pin you down to a specific number, but would that add 2 points to the M's or would it add 10 points to the M's?

Mr. VOLCKER. No, I don't think it would have added a significant amount to those particular M's in 1983, with an exception. We do not include, as a matter of definition, time deposits that banks acquire abroad from foreigners. We expect that that will become an increasingly large source of funds to the banking system. There's been some reversal there in 1983. We expect it will become an increasingly large supply of funds in 1984. That enables us, in a sense, to live with a lower M_2 and M_3 and it bears upon the technical reasons as to why we reduced the M_2 targets. We are counting on some of that supply of foreign capital to relieve pressure on the aggregates and relieve pressure on the money markets. It doesn't appear in the numbers, but if we didn't have that channel there would be more pressures on the domestic money markets. It's just another way of illustrating our vulnerability to the inflows of foreign capital now.

Our accounts will be balanced by an inflow of foreign capital, by a large inflow of foreign capital. Any way you look at it, that's not a comfortable position for the Nation to be in.

Senator HEINZ. Would you also agree that the continued deterioration of our trade deficit which was $30 billion last year, $70 billion this year, apparently by estimates headed to $110 billion, that one of the consequences of that besides loss of employment is that that affects some of our most competitive industries?

Mr. VOLCKER. Yes.

Senator HEINZ. The ones that are traditionally able to compete?

Mr. VOLCKER. Yes.

Senator HEINZ. And that we take a very large long-term cost in those industries, would you agree with that?

Mr. VOLCKER. Yes. I think that's one reason why this situation is basically unsustainable.

Senator HEINZ. My time has expired. I just want to comment that with your usual and understandable artistry you have answered my questions with great skill, but I didn't hear you deny the fact that perhaps in order to get the Congress to act, it will be necessary for you——

Mr. VOLCKER. Well——

Senator HEINZ. Excuse me. I will yield to you as soon as I finish my sentence. That it will be necessary for you to pursue your cur-

rent careful, moderately restrictive monetary course, which by the way most members of this committee, with some possible exceptions, probably feel is the right and responsible course for you to pursue, but I think it would be a mistake if we left the impression that only if you do pursue such a course are we going to create the political pressures to really get the congressional commitment to deal with the deficit.

Now you may not want to admit that. You may not want to agree with it. I'm not asking you to agree with it.

Mr. VOLCKER. Let me amplify. I think we have no choice but to pursue that kind of course, but I think what you implicitly hold out as an alternative—a more accommodative course—isn't going to avoid any crisis. It may make it worse.

Senator HEINZ. What makes you think I hold that out as an alternative?

Mr. VOLCKER. I just don't think you can escape this problem.

Senator HEINZ. The President may hope that that is your alternative.

Mr. VOLCKER. I don't think it is a real alternative. It doesn't fit with the economics of the situation.

Senator HEINZ. We're going to have a very interesting hearing in this room 1 year from now.

Mr. VOLCKER. I always find them interesting.

Senator HEINZ. And I'm going to make a note and reference the testimony here about how Paul Volcker said 1 year ago that he wasn't going to do anything to liberalize the monetary policy and it would be very interesting in February 1985 when Ronald Reagan is reelected and there's been a good economic performance, unemployment has continued to come down—it will be a fascinating hearing. And I don't want to prejudge it.

Mr. VOLCKER. Since you're recording all this, it's in no way contradictory to anything I have said, in my judgment. I would refer back to the earlier colloquy with Senator Garn; I think the one technical reason for raising the targets would be if, in fact, the relationship between monetary growth and the nominal GNP, to put it in the jargon, deviated from the basic assumptions that in setting forth targets in the first place.

In other words, if we had a continuation of no change in velocity or a decline in velocity, and we knew that was happening, these monetary targets would be too low, but not for any reason you're suggesting; they're too low in terms of what is appropriate in terms of our own goals over a period of time. That assessment has to be made as the year progresses.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Chairman, my time has more than expired.

The CHAIRMAN. Unless Senator Lautenberg has talked Senator Riegle out of his turn, once again we now turn to the ever-patient Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

$50 BILLION FIGURE SEEMS REALISTIC

I want to make an observation related to some of the earlier discussion. That is with respect to this meeting today of the so-called

bipartisan group to try to find a way to move toward this downpayment, as it's called, in reducing the deficit. And I'm concerned about the fact in my mind that it's not a serious effort.

The Wall Street Journal today in its summary piece on this indicates the group is meeting at Blair House and the two Democratic people present have said they're there "only to listen to Republican proposals," and then it goes on "but White House and Republican congressional aides say they don't have any proposals to make yet." So it sounds to me like we're a long way from coming to grips with this thing.

Just to contrast that, I was thinking about it today as I was listening to your earlier discussion with Senator Sasser and some of the others, I was thinking to myself, well, where's the President in all this? Well, the President is on vacation today out in California, and he is entitled to vacation, but I think it paints a picture of stark contrast to the one of urgency in coming to grips with this problem.

I don't detect a real sense of urgency at the moment from the President on this, quite frankly.

Let me give you a different picture to think about and then I want to ask a question of you. If today the meeting were taking place in the Cabinet room, if the President was there with his coat off and his shirt sleeves up, if Tip O'Neill was there with his coat off and his sleeves up, and they were starting in in a serious way to come up with some deficit reduction package, and they were determined to meet over a period of days or even 2 or 3 weeks if necessary to hammer this thing out, I'm convinced we could reach an agreement. The sense of alarm today in the Congress in both parties is now high enough and there is a real desire here to find that kind of package, and I think it can be found.

I think last year in the Budget Committee people like Senator Gorton, myself, and others were able, despite some difference, to work out deficit reduction packages that came forward in the Senate. They didn't pass by much, but they did pass by bipartisan majorities, and I think today the sense of urgency is even greater.

But I just want to say to you that if the President, who is the key leader in the country, is going to be both uninvolved and disconnected in any active leadership way along with the leader in the House and the Senate, it won't be real and it can't move very far, and I think the financial markets sense this. I think generally it's understood that there is not a real sense of urgency. Otherwise, the President would not be in California today while this rather lame effort starts down at the Blair House.

Now let me try to ask an entirely different question than I've heard asked today and I want to stay out of the question of tradeoffs and how we reduce the deficit as between cutting defense or revenues, or domestic spending, or entitlements, or what have you. But as you look at the 1985 fiscal year picture in terms of the size of the deficit reduction that you would like to see, recognizing that we should try to shoot for some number, and we don't want to have too little and we obviously don't want to try to go so far in one step that we tip the economy over into a recession—I'm wondering, just from a macroeconomic point of view, what is the size of the deficit

reduction for fiscal 1985 that you think would best strike that balance?

Mr. VOLCKER. I expressed a view yesterday and earlier today that you can't just pick a round number out of the air, a figure that makes an impact on psychology and events in a very visible way. I threw out the figure of $50 billion and Senator Garn said $30 to $50 billion. That's a pretty good range the first year. It's not a range that delights me as the end of the process, but begins to make an impact and carries a promise of more in the future, I think.

Senator RIEGLE. So you would like to see for fiscal 1985 the number that you select as being the one that would do the most good in terms of striking this balance would be $50 billion; is that correct?

Mr. VOLCKER. In that neighborhood; I would certainly like to see that and more as you get beyond 1985.

Senator RIEGLE. The reason that I want to pin down your best estimate is that if you could pick a different number—you could say $40 or you could say $60. You've elected to say $50. I assume that's because you think that really is the size we ought to be shooting for in 1985.

Mr. VOLCKER. I think that's a very hard number to get, practically by fiscal 1985. You're only 9 months off from the beginning of that fiscal year. As a practical matter, I'll accept Senator Garn's range.

Senator RIEGLE. Well, that's a politic way to do it.

Mr. VOLCKER. It's not only politic, it's a practical matter.

Senator RIEGLE. We don't know right now what is the practical matter. If the risk of a crisis down the road is as great as you think it is and I agree with your view on that, it may well be possible that if $50 billion is your notion of what is really the number we should be shooting for that gives that number a lot more weight and credibility. I'm willing to shoot for that target if that's your best judgment.

Mr. VOLCKER. It's something in that area, yes.

Senator RIEGLE. How about fiscal 1986?

Mr. VOLCKER. It should get progressively bigger. As I see it, you would want to be aiming against the current projections of the current services budget or the baseline budget and by the time you get out to the end of the decade you're probably talking $150 billion or more. You can get some help when you go out that far from this compounding effect of lower interest rates.

Senator RIEGLE. I understand that and I agree with you on that and the trick is to get to 1989.

Mr. VOLCKER. You have to begin getting that momentum so it feeds on itself.

Senator RIEGLE. Well, you've given us your best judgment on fiscal 1985. What would you think the number for fiscal 1986 should we shoot for? Let me just say this, in the Budget Committee, as you know, we'll be reporting out a 3-year budget, so we'll be trying to set targets, including deficit targets, for the 3 years. So what would you like to see us reduce it by in fiscal 1986.

Mr. VOLCKER. I just have not sat down and looked at these figures specifically enough to give you any figure.

Senator RIEGLE. But something more than $50 billion.

Mr. VOLCKER. Certainly more than $50 billion. I've been sitting here and feeling that what would really satisfy me is something somewhat greater than any target you're going to get practically speaking. I want to encourage you to get all you can get.

Senator RIEGLE. Let me just say to you, if the potential crisis is as large as many of us think it is, I think that may create a possibility to do what we should do for a change. So don't give up the game before we play the game.

Mr. VOLCKER. I don't want to give it up and I'm not giving it up. What I see is a magnitude of $50 billion in the first year, and then you've got to get up to $150 billion or maybe considerably higher than that by the end of the decade; taking account of the savings you can make on interest and on the deficits that is the kind of path you're going to be on.

Senator RIEGLE. So then, if we do that, then over say a 5-year period you're saying something like a deficit reduction of $150 billion in the last year, in 1989. It would probably be up around maybe $75 billion in fiscal 1986, something like that?

Mr. VOLCKER. I would think in that neighborhood, yes.

Senator RIEGLE. And maybe $100 billion by 1987?

Mr. VOLCKER. You would have to be up there, but you would then begin getting the benefits of the lower interest rates.

Senator RIEGLE. I understand. But if that's the track, if your best judgment as the person who is sort of in the center with having to manage and help sort of construct the monetary policy, if that's the kind of guidance that we're getting from you, I think those of us who are on the Budget Committee can be helped greatly by trying to lay out a spending path, or a revenue path, or a path with respect to entitlements that can produce that kind of deficit reduction over that period of time.

Mr. VOLCKER. There are a lot of errors in estimates when you get out that far. But what I'm saying, to put it another way, is that I would like to see—and by the end of the decade there's a reasonable prospect—is, if not a full employment balanced budget, then a deficit that's not so big that it's a drag on our investment potential and our foreign trade accounts and all the rest. You get down to either zero—I'm talking now about a full employment deficit—or 1 percent of the GNP, or 1.5 percent of the GNP. Nobody at this time can say that that figure is devastating compared to where we are, but that's the kind of range which one ought to be shooting for.

RISKS OF PUTTING OFF LEGISLATION UNTIL 1985

Senator RIEGLE. Let me ask you a different question and I ask this question not to shake up the financial markets because they are nervous enough but to try to create a sense of the stakes involved here in the Congress so that we take the steps we should take and that you're encouraging us to take.

If we don't get any material deficit reduction this year, we don't get the $50 you'd like to see or the $30 billion that's been talked about, what do you see as the risks that we're running? In other words, in 1985 some economists have said that they see the possibility that a recession might come along somewhere in there and

they come on a cyclical basis and the deficit might go up even above $300 billion.

As you know, OMB has said that they can see that kind of thing happening. I'm just wondering, without being an alarmist, if you can help us understand the risks involved if we sidestep this problem for 1 year, 1½ years, or 2 years.

Mr. VOLCKER. Let me put it in two categories, if I may. The first category doesn't seem to me in the nature of a risk but much more in the nature of a certainty. If nothing is done, the good news, so to speak, is that we'll have rather lackadaisical or depressed housing; we will make little progress toward expanding our plant capacity; the corporate balance sheets will remain somewhat strained; the thrift institutions will remain on the margin of profitability, not in a very good position; the economy will continue to grow simply under the force of all this purchasing power; and the foreign trade picture would remain poor and the dollar vulnerable. All of that is the good news.

On top of that you're talking about risks. I don't think you're talking about a certainty by any means, but I think you are talking about the progressive possibility of loss of confidence in the dollar abroad and a pulling back of that voluntary inflow of capital and the shock to inflationary prospects that that sudden drop in the dollar implies. Without the flow of foreign capital coming in freely, you're talking about pushing all of that financing load onto the domestic markets and the domestic saving capacity isn't big enough to take it. So, under those conditions, you are talking about the potential of further pressures on interest rates and dislocations in the economy that could even produce a recession, despite all the purchasing power, because of the degree of financial disruption.

Another one of the risks that's tied in with that is aggravating this foreign debt problem in such a way that you create a lot of uncertainty about the flow of funds through the American banking system.

Those are the kinds of risks that you pile on to what I call the good news, which is not entirely good news from the standpoint of the sustainability of the growth of the economy.

I suppose one way of putting it is that you haven't got a very good basic outlook; you've got some imbalances; and you're playing a kind of Russian roulette the longer this goes on.

Senator RIEGLE. I gather you're saying to us that time is running out.

Mr. VOLCKER. That's right. These are the kinds of things that nobody can predict with accuracy. If you're lucky, you avoid them. The longer it goes on the greater the risks, and you don't want to wait until a crisis before you take action.

Let me put it positively. I think the situation is so obvious. We can deal with these risks. It's within our capacity. And the way to approach it is to take the action that's so clearly necessary to capitalize on what otherwise is a very bright picture, it seems to me. A lot of progress has been made, and there's every reason to foresee the possibility of crisis and to act to avoid it; we're in a position where we can do that.

Senator RIEGLE. As long as we do it now?

Mr. VOLCKER. That's right. The longer you wait, the greater the risks. Why wait?

Senator RIEGLE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

I'm sorry that I missed a great deal of this hearing and I do not wish to duplicate questions, so I'll only have one or two. I do want to thank Senator Riegle for the compliment with which he began his point that, unfortunately, the victory we had last year was parliamentary only and was not turned into substance and it is that substance that we're here now discussing today.

Mr. Chairman, you emphasize in your testimony the importance of the international balance-of-payments deficit at least as much and perhaps more than any other commentators do, and you state that the current rate of capital inflow is not sustainable, which seems quite evident over the long run.

Directing your thoughts to the members of this committee and the jurisdiction of this committee, should it be focusing its attention on specific policies aimed at correcting the balance-of-payments deficits or, in your view, are they so overwhelmingly impacted by the Federal budget deficit problem that from a governmental standpoint that's the only way or the chief way with which we must deal with it?

Mr. VOLCKER. I think that there are other things that are structurally important over a period of time and should always be worked on, but I can't think of any particular measures that carry anything like a promise of a quantitative impact over the time period we're talking about of 2 or 3 years.

The temptation, I think, is to go in a nonconstructive way, and that is to say the trade problem is terrible, it puts a lot of pressure on some of our very good industries as well as on some of our weaker industries, so we will protect them all. I think that is a snare and a delusion, not only because it will invite retaliation, increase inflationary pressures—and all the standard arguments, which I think are very valid—but also because by not going to the basic part of the problem the pressures will pop out in another direction. Theoretically, you can improve the trade balance for Caterpillar tractor, or the steel industry, or the textile industry and so on by taking specific, protectionist measures. But then, if the capital continues to flow in because our interest rates are high, I presume the dollar would go still higher and that would hurt another industry. You would have to then chase your tail and end up with nothing but a lot of protectionism. You haven't dealt with the basic problem, and you've got all the disadvantages of the inflationary pressures, the lack of competition, and all the rest.

Senator GORTON. So basically, it doesn't matter what aspect of our fiscal challenge we look at, our international trade deficits, the budget deficits, high interest rates, the value of the dollar—they all bring us right back to those budget deficits.

RESTRAINED WAGE SETTLEMENTS AND REDUCED PRICES

Mr. VOLCKER. I think we're all caught in a circle, or a maze, or a grid lock—however you want to express it—and we're all looking

for some way to get out of the box. To deal with these hazards and risks that are arising, you have to look around to where you've got some leverage. I think monetary policy is consistent with the long-term needs of the economy. What about the fiscal side? Is there something there that we should be taking and doing and inevitably will have to do sooner or later in our own best interest? Does it help this problem? Does it help us get out of this box? It seems to me the answer to that is obvious. Sooner or later we're going to have to do something on the fiscal side anyway, because the situation is basically unsustainable.

Can it break this logjam? If it's done right, sufficiently, forcefully, I think the whole of economic analysis and the whole economic sense says, yes. So let's do it.

Senator GORTON. One other question. In your written testimony you emphasized the necessity of discipline on the part of both business and labor and keeping both wages and prices down. If the rate of inflation is, in fact, subject in any degree to our will in this way, does that imply some kind of jawboning policy on the part of the Federal Reserve Board as well as on the President? Do you intend or will you in the future specifically comment on industry wage settlements which you regard as excessive?

Mr. VOLCKER. I will tell you the kind of jawboning policy that I think it does imply; it implies that jawboning is only the preliminary. It implies a sense of conviction that through monetary policy we will not provide the financial or inflationary environment that makes it worthwhile to engage in inflationary, cost-increasing wage settlements or other practices.

I think it's essential that we provide that environment and conviction, because that should encourage—to the degree we can influence this through our actions—that kind of response. But I think you have to recognize the danger arising out of history; the history of the 1970's was inflationary and that kind of wage demand paid off. It didn't pay off in the last couple of years, but there's still a lot of feeling around that that was all temporary and things are going to change again, so let's go back to what is considered normal. What's considered normal is the 1970's.

I observe that many restrained wage settlements these days are called concessions. Some of them are true concessions in the sense that an old contract was opened up; but I don't think we ought to be in the habit of calling a moderate wage settlement a concession. That should be normal.

What should be abnormal was what was considered normal in the 1970's when the increased in wages was 10 percent. If that's considered normal, then we've got an awful problem. I think we've got to encourage an environment in which moderate wage settlements are the norm as they were in the 1960's, and we get some productivity increase and real incomes will go up. During the majority of years after 1973 or 1974 real wages went down, despite very rapid increases in nominal rates, because they were always trying to catch up to prices. In the last couple of years we've had the situation where with prices coming down and coming down sharply in terms of rate of increase, wages have also been coming down nominally; but, lo and behold, we've had an increase in average real wages both in the last 2 years. That's what it's all about.

Let's get moderation on that side. Let's get some productivity growth, increase in real wages, and some more employment on top of it.

I think that lesson ought to be reiterated frequently—ought to be shouted from the housetops, in my opinion. In a very general sense, I see some promise in the practices that have developed in the recession, under a lot of pressure. Doesn't it make sense to have more profit sharing; otherwise you build in a great big base wage when General Motors profits are good 1 year, and then they're stuck with a high cost structure. Why can't you get some arrangement where those benefits can be extended to the workers so they share in the prosperity without building in a high level of cost? That's a controversial thing, but it seems to me it has some promise.

There have been other initiatives along that general line. I think it's a good idea to encourage that kind of initiative. If that's jawboning, so be it.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg.

Senator HUMPHREY. Mr. Chairman, if the Senator from New Jersey would yield, are we under some kind of rule? I'm trying to make some plans here. I have to preside at 12.

The CHAIRMAN. We have a 10-minute rule.

Senator HUMPHREY. OK. Thank you.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you very much, Mr. Chairman.

Chairman Volcker, it's always interesting to hear your points of view and the question raised these days is whether they're yours or, despite your acknowledgement of independence, whether there isn't some pressure coming from higher sources. Obviously you disagree with present fiscal policy because you're not at all satisfied with what we're doing at this point with the deficit projected—at least the deficits—forget the projection. As for the model, I was going to recommend you go to a company I know that does economic modeling, that does very good programs and sold very cheaply, but I'm not out to do that here.

Mr. VOLCKER. I have nothing against economic modeling. I think it is useful. I don't think models capture all the extraordinary things going on in the economy.

Senator LAUTENBERG. Before I oversell my former company, I would suggest there's some good ones out there if they happen to catch your eye.

On a more serious side, your view of present policy is that it's insufficient, doesn't approach the debt reduction that you feel is essential and obviously you would take some measures to change that. You implied or suggested several revenue enhancements though you don't want to pick out on the expenditure side where things ought to be cut back, and I respect that.

Is a tighter monetary policy required at this juncture, do you think? Let me start from a different perspective. How long do you think that this recovery can go on without bumping flush into an expanding deficit?

Mr. VOLCKER. In a sense, it's probably bumping now, but I think my basic view is that we have a lot of the ingredients for keeping this expansion going on indefinitely—although expansion does stop

at some point. I think we have the kind of potential change in productivity. Most importantly, I think we have an actual and potential change in the financial environment and the inflationary environment in the direction of more stability. And, we have the background that should permit declines in interest rates that would help to keep the expansion going.

What you're asking is, against all those favorable factors, how damaging is the budgetary deficit and its effects in terms of the trade deficit and all the rest?

I don't think I can give any different answer than I gave before. If everything works out very smoothly, the optimistic view is that we could have a recovery or expansion that continues for quite a period of time but would be lopsided. It wouldn't be a good housing recovery and it wouldn't be a good trade recovery. It would be a lot of consumption recovery. That's not our ideal kind of economic environment, but I can't say that's what most economic models would show.

Senator LAUTENBERG. Is the purchasing power there to continue consumption?

Mr. VOLCKER. The purchasing power comes out of the budget deficit in that kind of environment. You've got an economy where the purchasing power is fed by the budget deficit and the rest of the economy doesn't do very well.

Senator LAUTENBERG. The definition in this case of consumption is Government consumption or individual consumption?

Mr. VOLCKER. That depends on the rate of Government spending, but both Government consumption and individual consumption are certainly included. Government expenditures themselves, of course, are Government consumption; so you have a lot of defense expenditure under present plans. You have a lot of personal consumption, basically being fed by the deficit, and relatively restrained investment and housing and an unfavorable climate for international trade.

Senator LAUTENBERG. It doesn't seem like that's a sustainable thing.

Mr. VOLCKER. You can raise that question. It's certainly not sustainable to the same degree that a more balanced recovery would be. But then, if you trigger some of these financial problems, international or domestic, then indeed you have the threat of cutting the recovery short.

Senator LAUTENBERG. Do you think that the $180 billion projection for 1985 for the deficit size is realistic?

Mr. VOLCKER. That already rests upon some proposed savings. Is it realistic?

Senator LAUTENBERG. Would you think it's optimistic?

Mr. VOLCKER. I suppose in a sense it's optimistic if nothing is done. I don't minimize the political problem; as I see it, you have a political problem, which is very real of getting a consensus on difficult measures. The problems are not insuperable. There's nothing that says that you can't take either revenue or spending action in an amount necessary to cut the deficit to $180 billion or significantly below, as I would like to see. It takes action, but it doesn't take impossible kinds of action.

What it takes is a consensus and it is getting that consensus that I see as the difficulty.

Senator LAUTENBERG. I haven't been here long enough to forecast the political realities in a national election year, but I'm not optimistic about the ability to get the revenue side of this thing bolstered in any way and frankly it's my view that spending reductions are very limited also as a result of the election climate.

If we had an ability to increase the revenue side, could you project what size tax bite, if one were to be developed, would be so significant that it might restrain or abort the recovery?

Mr. VOLCKER. I don't think you can look at the revenue piece of it in isolation. I think it is true that if one attempted to do it all on the revenue side it would involve either such increases in general tax rates, or such widespread loophole or special provision closings that it's hard to conceive.

Senator LAUTENBERG. I like special provision closings.

Mr. VOLCKER. Yes. I shouldn't use the word loophole, but you would have to go back and look at the depreciation——

Senator LAUTENBERG. But that's the one that everybody understands so well.

Mr. VOLCKER. But it would involve rather sweeping changes in those provisions. Entirely apart from the political practicality of that—which you would be a better judge of—it might involve a question as to the degree of shock in a short period of time from eliminating provisions that a lot of people have been counting on; I don't think that's entirely desirable. That's one of the reasons I wouldn't like to see this all done on the revenue side. In fact, quite the contrary, just looking at it from the economic standpoint, without denying there are very other important considerations, the more that can be done on the spending side, the better.

As you know, our revenues are running more or less in line with historical peaks relative to the GNP. It's the spending side that's sharply higher

DECLINE OF CORPORATE TAXES

Senator LAUTENBERG. We talked before for a moment about the corporate contribution to revenues and I think in your statement it says that the rate of increase of corporate income tax is behind that traditionally seen in a recovery or at least not seen even going as far back as the 1960's.

Mr. VOLCKER. We've had a very good growth in profits, helped by both the economy and by tax changes. In terms of the general level relative to GNP, we are approaching what was typical of the best years of the 1970's. But the best years of the 1970's weren't very good in historical perspective; we are still well below the peak years of the 1960's which extended over a period of time.

As I remember the numbers, the after tax profit share of GNP is running around 5 percent now, which is about where it was in the best years of the 1970's; back in the 1960's it ran 7 percent or higher, which would be 40 percent more.

Senator LAUTENBERG. You're talking now about the percentage of profit?

Mr. VOLCKER. Percentage of after tax profits to GNP.

Senator LAUTENBERG. I'm talking about the contribution to the Federal revenue of corporate income tax.

Mr. VOLCKER. That's been declining over the years. It may be up this year with the recovery, but in general a lot of changes have been made in corporate taxes, as you know, and that's reflected in a lower share of corporate tax receipts.

Senator LAUTENBERG. OK. Even though the corporate profit recovery has been consistent?

Mr. VOLCKER. The estimate I have in front of me to get perspective, shows that back in 1970 corporate income taxes were 23 percent of total revenues. Then they began declining. By 1970, they were 17 percent. Last year they were only 6 percent of the total revenues, a little more than a quarter of what they were in 1970. This year, the projection I have in front of me, which is the administration projection, shows it growing close to 10 percent—that's recovering from the cyclical low—and it kind of hovers around 10 or 11 percent looking ahead. That's less than half of what it was in 1960 and it's well below what it was during the 1970's.

It's been on a generally declining trend; the estimate has it up to 11 percent assuming the economy is back more or less to full employment.

Senator LAUTENBERG. Again, 1 second, Mr. Chairman. Just so I understand clearly, are you talking about percentage of after tax profits?

Mr. VOLCKER. I'm now talking about percentage of Federal revenues flowing from corporate income taxes.

Senator LAUTENBERG. You're saying it could be as high as 11 percent?

Mr. VOLCKER. That's the administration projection. That's in 1987, when the economy based on their projections is operating close to a 6-percent unemployment level, so that's at a full-cyclical recovery.

Senator LAUTENBERG. That's 11 percent in 1987 and this year, do you have that number?

Mr. VOLCKER. This year it shows 9.9 percent; last year, 6.2 percent, the bottom of the recession. One of the problems was that the corporate tax receipts were reflecting the recession last year.

The CHAIRMAN. Senator Humphrey.

Senator HUMPHREY. Thank you.

Mr. Volcker, let's get something out of the way right at the beginning. I think fiscal policy stinks in this country and we can assign the blame for that as we will. I agree with the chairman that under the Constitution the blame lies with the Congress.

But putting aside fiscal policy and monetary policy, there's been a lot of talk in the press lately and a lot of nervousness in the financial markets about the degree of restraint or otherwise in the monetary system policies of the Fed.

Is the Fed pursuing a monetary policy at this juncture that is tight, loose, or just right?

Mr. VOLCKER. I obviously will answer just right in my best judgment.

Senator HUMPHREY. If it's just right, why is there all this talk and why is there enormous nervousness in the financial markets about why the press reports to the effect that the minutes of the

December meeting of the Open Market Committee indicated that the Fed might tighten monetary policy in the months ahead?

Mr. VOLCKER. I don't know when I could have been sitting here when you couldn't have made the same comment. There's always a good deal of concern whether money is too tight or too easy.

Senator HUMPHREY. Yes, but is there a special reason for that?

Mr. VOLCKER. I don't sense that it's much more a matter of concern than it usually is, with one exception. There is one school of economic thought which is particularly concerned about the rate of slowdown in M_1 growth in particular in the second half of last year. At least some monetarists have been quite concerned that that was slower. That ingredient is not always there.

Senator HUMPHREY. Right. But with respect to the minutes of the December meeting of the Open Market Committee, is there any reason to suppose—I haven't read the minutes, but you know about them—is there any reason to suppose or speculate there's going to be tighter monetary policy in the next months.

Mr. VOLCKER. That December meeting has been reported. The minutes are released. The committee decided to maintain the degree of reserve restraint that it had, but it also suggested that, if things developed in a certain way before the next meeting, some slight tightening might be in order.

As it turned out, nothing was done, and I think we take a more balanced look at things at the moment.

Senator HUMPHREY. Well, you always have that caveat, stated, or implied, that if things change, you're going to change policy.

Mr. VOLCKER. It's always implied, but these directives give, in effect, a basis for instruction to the people who actually do the operations inbetween meetings. You can always have another meeting; that right is always reserved, and we're always flexible in that sense. But the committee in effect gave some instructions to the manager of the Open Market Account as to how to deal with some contingencies; and that's what they were doing in that meeting. The contingencies did not arise.

Senator HUMPHREY. Let's assume that the stock market has tumbled on the basis of these pressures. With that assumption and that assumption only, do you think that was a justified reaction to the minutes of the committee?

Mr. VOLCKER. I don't think so. What motivates the stock market is not always very clear from day to day.

Senator HUMPHREY. I know that. I'm aware of that.

Mr. VOLCKER. The stock market had declined for at least 1 week—I think 2 weeks—before that was released.

Senator HUMPHREY. Yes, but it began to descend with real alacrity just a few days ago.

Mr. VOLCKER. It descended with alacrity 1 day after that report was released and then yesterday it went up; I don't know what it's doing today.

Senator HUMPHREY. I'm trying to influence it by these questions.

Well, my last question, on page 14 of your testimony you state that: "the objective of monetary policy is simple to state and widely agreed: to provide just enough money to finance sustainable growth and not so much as to feed inflation."

Mr. VOLCKER. A nice textbook definition.

Senator HUMPHREY. Yes, it's nice, clear, terse stuff. So you try to moderate between these two extremes.

The problem is you really never know when you're testing either extreme.

Mr. VOLCKER. Precisely.

Senator HUMPHREY. I would urge you and I will end with a statement because I don't have time for an answer—I would urge you and your colleagues in testing those limits as the months go by that you keep in mind we have descried the irresponsibility of fiscal policy of the Congress, but as to monetary policy I would urge over the next few months that you test these limits on either side. The one good tool that we have going for us now in narrowing these deficits and the only tool at the moment is growth in the economy. I hope that you're not going to damage or destroy that one good tool we have and I worry very much at least there's a perception that you will and that counts.

Mr. VOLCKER. Perhaps we have more interest than anybody else in seeing in some sense the economy follow an orderly growth path. The only other comment that I would add to that is we have to be worried about not just what happens in 1984, but what happens in 1985, and what happens in 1986, and that is the reason why we are as sensitive as we are to the inflation side of the equation as well.

Senator HUMPHREY. Yes. Well, I just wanted you to be sensitive about growth because if we damage that, then it's all over. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Humphrey.

TAX INCREASES HAVE NEVER SOLVED THE DEFICIT PROBLEM

Mr. Chairman, there's been a great deal of discussion today about how we achieve deficit reductions and certainly you well know my attitude for a long number of years about deficits. Some of us who are here, notably one Republican and one Democrat at this point, have voting records that match our rhetoric about deficits. That is not true of some of our other colleagues on both sides of the aisle who make great speeches now about how we've got to reduce deficits but their past voting records have been the reason that we have the deficits. They are suddenly born again converts to balanced budgets, and most of those, interestingly enough, talk about solving the problem with tax increases.

You have stated many times that you thought a mix was desirable and have stated here again today that it would be desirable to have more on the spending side. I have challenged a lot of other people with this question and I would ask you at least in the time I've been in the Senate, which is 9 years, can you give me any indication of where a tax increase, of which we've had many over those 9 years, has resulted in a reduction in the deficit?

Mr. VOLCKER. I'm trying to remember right now when we had tax increases. We had one back in 1968, but it was much delayed.

The CHAIRMAN. That's prior to my time. Let me give you an example. I sat on the floor of the Senate in 1977 and was told that if I would vote for the social security tax increase at that time, which I did not, it would fix the system for 75 years. Even by congressional

standards, to miss our estimates by 70 out of 75 years is a little bit gross. I also sat on the floor of the Senate and listened to the debate over windfall profits, a tax which admittedly because of the fact energy prices and usage have gone down has not produced as much as they estimated; but nevertheless, still one of the biggest tax increases in the history of this country, and you can go back and look in the Congressional Record and what you will find is debate over how we would spend the surplus from that revenue increase, and there have been others since I have been here, including TEFRA in 1982 which is the only one that I have voted for on the basis that, look, I didn't like tax increases; I preferred spending cuts just like you, but the deficits were so important to me that I would swallow that feeling and vote for $98 billion on the basis that we would either get anywhere from $1 to $3 of expenditures for each $1 in additional revenues and if you took the minimum, most conservative figure, that would give you $196 billion of deficit reduction over a 3-year period. That sounded like a good deal to me. What did we get? We got a $98 billion tax increase and for each dollar of revenue increase we got about $1.04 or $1.05 of spending increase.

It reminds me of a brother-in-law of mine who was making $12,000 a year. He answered all of his financial problems, rather than chapter XI, with an increase in pay. He was fortunate enough to get a $40,000 a year job, but he spent $50,000. He now makes over $100,000 and he's constantly on the verge of bankruptcy because he's never disciplined his spending side, even though his revenue has increased dramatically.

Now it's exactly the same picture in the 9 years I have been in the Senate. We have increased revenue dramatically. We've had tax increase after tax increase.

So forgetting the philosophy, the practicality, if my colleagues would look at them, when they say let's increase taxes to solve this problem, it hasn't worked before. It didn't work in 1982. And so that's why I'm not in favor of a tax increase. If I could be guaranteed even if we would not get 1 dollar of expenditure reduction, if we would just hold spending so whatever we increase taxes would reduce the deficit I would be willing to swallow my feelings about how much taxation as percentage of GNP, whether it's too high or not, or what it sucks out of the private sector. But it just hasn't happened. My colleagues are entitled to their own opinions, but they are not entitled to their own facts. I guess it's nice to talk about doing it easily, don't cut anybody's programs, but increase taxes.

So I don't think you can find—I have researched it rather carefully and at least in the last 9 years we have had several tax increases, and none of them have had any impact on the deficit reduction because in each case we have spent more money than the tax increase raised, and that was true in 1982 as well.

Mr. VOLCKER. I suppose the question is whether you would have spent that money anyway.

The CHAIRMAN. You're right. I would agree with you that the deficit would have been somewhat higher. But nevertheless, we are talking about deficit reductions. We have slowed with those tax in-

creases probably the rate of increase, but we still have a $180 billion deficit and it continues to grow.

Mr. VOLCKER. There's no question that we're not going to solve this problem without discipline on the spending side.

The CHAIRMAN. That's where I get back to my point. We can try and blame this administration, or the Carter administration, or any other administration and talk about the need for leadership and whether they're in California or whether they're not. The point is, damn it, Congress can change it if they want to. It doesn't make any difference what Ronald Reagan sends up, a $300 billion deficit, or I can remember when he sent up one for $45 billion. He could have gone either way, there's no doubt about that, because then his estimates were unrealistic and so he sends up one that is realistic and that's too high and everybody says it's bad. So I realize that whatever he sends up would be criticized by certain people.

But the point is, remove Ronald Reagan from it and look at the Office of the Presidency and look at the Constitution and if my colleagues, the majority of them in both parties, really mean all this rhetorical baloney that is going on in an election year, then they can change it. What about the leadership in the Congress? When are we going to get some here to reduce spending? That is the point of this debate. I will vote for a tax increase once again when we devise a method in this body that in one vote the expenditure reductions are tied with the tax increase so that I won't be lied to again. That's the major reason the President is opposed to tax increases, because he was conned just like the rest of us with some promises which were not fulfilled by the legislative body in 1982.

So these people that are meeting today, if they come up with some kind of a compromise that entails both at the same time—maybe we ought to do it the other way—maybe we ought to have the spending cuts and promise them we'll come up with tax increases and see if they will trust us. I doubt it. Well, some of us aren't going to trust them the other way.

From a very practical, pragmatic standpoint, tax increases simply will not solve the problem. They never have. And that is the fact, not fantasy, or opinion, or partisan rhetoric. They haven't and no one can show me an example. Just the reverse. In 1962, John Kennedy's tax cuts produced far more revenue than they lost because they stimulated the economy. So Senator Humphrey's point is very well taken. All of these things we're talking about are not going to solve the problem unless we get growth in the economy and continue to have the unemployment rate go down.

I guess after that speech, without getting into the priorities, would you agree that in order to solve this problem we have got to cut out the rhetorical baloney—or I could use another word that also starts with "b" and the first word is "bull"—or are we going to get going with expenditure reductions and tax increases so that deficits come down rather than taking more money off the American people?

Mr. VOLCKER. I would suspect that's the only way you're going to get an unlocking of this gridlock. But I would go further and start from the position—again, economically speaking—that if you do it all on the expenditure side that would be even better. That ought to be the predisposition from which you start, as far as the econom-

ics. As a practical matter, I think you're going to end up with a combination.

The CHAIRMAN. Let me ask you one more question about taxation and reducing deficits. Let's take $200 billion so I can subtract more easily, and assume we had a $30 billion tax increase, no increase in expenditures, and we say, isn't that great; we've achieved $170 billion deficit which is progress, a good downpayment the first year. OK. We saved the interest on that $30 billion, but if you do it with taxation alone, isn't it true that we're still taking $200 billion out of the private sector, that we're still crowding out money that's available for mortgage loans, automobile loans, consumer finance, venture capital, investment in new plant and equipment, and creation of jobs? What will you take? $170 by borrowing and $30 billion more by taxation and you still remove $200 million less the interest on that $30 billion from the private sector.

But if you reduce it by $30 billion expenditure cuts, that $30 billion is out in the economy, is it not? And at least if you get a combination of $30 billion and $30 billion, then you've got $140 billion deficit, but much more positive results because you have left $30 billion in the private sector. True or false?

Mr. VOLCKER. True and false, I guess I would say. In a sense, it all comes out of the private economy. The spending does, too, but the interest point is important here. It's not only $3 billion the next year extra from borrowing; that compounds on itself. You've got the next $3 billion plus the interest on the first $3 billion, so the second year it's $6.3 billion and the following year it's $9 billion, and so forth, just in terms of interest. With the amounts we're talking about, unfortunately, that is not unimportant.

Apart from that, depending on the taxes you increase, you get different effects on the economy. If you tend to take it out of the consumption stream, then you end up, I think, with a better balanced economy in the end. You end up with an economy that will, percentagewise—let's say the total is the same—have less consumption and more investment, more room for a better trade balance.

The CHAIRMAN. Are you advocating a value-added tax?

SHIFT IN TAX STRUCTURE COULD BE USEFUL

Mr. VOLCKER. I'm not advocating a value-added tax at this point. It's clear that this kind of change isn't going to be done this year; this is more in line with the Treasury reporting out in December. I think a consideration of a shift in the tax structure is very useful at this point. I'm wandering outside of my province obviously, in talking about present tax structure. It is still characterized by high marginal rates and shot through with a lot of exceptions, justified or not, and has some sense of breaking down. I think it deserves a look from the viewpoint of a broader-based, maybe consumption-oriented, tax.

A value-added tax is one form of that; there are other forms as well. It seems to me, if we are going to end up spending 23, 24, 25 percent of our GNP, we're probably going to have to find a different kind of tax base to help support that, because our present one doesn't seem to be able to.

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The CHAIRMAN. In general terms, you would agree that the impact on the economy, the positive impact on the economy would be much greater if deficits were reduced by spending reductions. On the other side of the coin, though, I assume you would agree with me that politically, not economically, the best solution in order to have it realized is a combination of tax increases and expenditure reductions.

Mr. VOLCKER. That's the way it appears to me. I would only add that in saying I'd like to see it on the spending side from an economic standpoint, I have not weighed in any judgment on how much defense spending we need, what the social priorities of the country are, and all the rest. Those are obviously relevant. But from an economic standpoint, I agree with the first part of your comment. My judgment, for what it's worth—and it may not be worth much because this isn't my bag, so to speak—is that the second part of your statement sounds right, too.

The CHAIRMAN. I didn't ask you specifics on where the cuts should come because I recognize that that is not your bailiwick, that is our judgment, and we can't pass it on to someone else, as much as we would like to do so. That is not your responsibility. It's ours.

Senator Proxmire.

Senator PROXMIRE. Chairman Volcker, you argued yesterday and today too that the investment by foreigners in this country investing in our deficit has its good side as well as its bad side, and you argued that on the good side is the fact that this provided more capital for various uses in housing and automobile purchasing and so forth.

One of the bad sides obviously is that foreigners don't like to see their capital absorbed by this country. It drives up their interest rates and it's difficult for them.

It seems to me that one easy solution which I'd like you to hit is that the Federal Reserve Board can provide that capital and you wouldn't have to borrow from abroad; instead of borrowing from Japan, or France, or Germany, you have a bottomless pit there and you can provide as much as you want to.

Mr. VOLCKER. There's one little flaw.

Senator PROXMIRE. You can provide as much as we need to replace that foreign capital.

Mr. VOLCKER. The Federal Reserve Board has no capital whatsoever. It's very limited, $1 billion or so. We have a bottomless pit in supplying money, but that's quite a different thing from supplying capital. And, people can go out and play with the money, but the money isn't going to be worth very much if they think it's a bottomless pit.

Senator PROXMIRE. Does it make any difference from that standpoint whether we borrow from Europe and Japan instead of borrowing from the Federal Reserve?

Mr. VOLCKER. Sure.

Senator PROXMIRE. What difference does it make?

Mr. VOLCKER. When you borrow from abroad, you're getting real resources. We are importing $100 billion more than we are exporting; that's what we are borrowing. Take the trade balance. Say the

current account is in deficit this year by $80 billion: that's what we are borrowing; that's something real. We haven't got $80 billion.

Senator PROXMIRE. The trade deficit is about $61 billion.

Mr. VOLCKER. Last year.

Senator PROXMIRE. That's right, last year. The current account is in deficit by what?

Mr. VOLCKER. $40 billion or so last year.

Senator PROXMIRE. Very little.

Mr. VOLCKER. $40 billion.

Senator PROXMIRE. The current account?

Mr. VOLCKER. Yes, last year. This is a new phenomenon. For 2 or 3 years it was in balance or surplus; then it was $15 or $20 billion in deficit the year before last.

Senator PROXMIRE. That's the kind of favor I would think that our own domestic manufacturers and so forth don't want and what you do is we're importing real resources. We're importing cars from Japan.

Mr. VOLCKER. That is exactly right.

Senator PROXMIRE. And steel from Germany.

Mr. VOLCKER. That's the distinction I'm making. That's the contribution in real terms that this foreign capital is making.

Senator PROXMIRE. That's not much of a contribution if you're a steelworker or an autoworker.

Mr. VOLCKER. But it's the contribution that takes the pressure off the savings. The Federal Reserve doesn't own 2 million cars, it doesn't own any steel, and it doesn't own any oil. Those are the real resources that are the counterpart of this capital inflow. All we have is money, and money isn't worth much if you supply too much of it.

Senator PROXMIRE. Well, I'd like some.

Mr. VOLCKER. We supply greenbacks, but people don't eat those.

The CHAIRMAN. I also would add that a lot of people still don't recognize that, in addition to providing for all of your own operating expenses, that you contribute about $14 billion in excess.

Mr. VOLCKER. $14 to $15 billion.

The CHAIRMAN. $14 to $15 billion of excess to the general fund of the Treasury, and whatever else people feel about the Fed, I can't find any other agency that reduces the Federal deficit by $14 or $15 billion.

Mr. VOLCKER. I think that's a——

Senator PROXMIRE. I'm not criticizing the Fed.

The CHAIRMAN. I know. I just wanted to make that point.

Mr. VOLCKER. That is the measure of the real resources that we command, that surplus. We already turn it over to the Treasury.

Senator PROXMIRE. You point out that we're borrowing about 2 percent of our GNP.

Mr. VOLCKER. That's the estimate for this year.

Senator PROXMIRE. And you say that pace is not sustainable. Could you elaborate on that and tell us why that level of borrowing is not sustainable and how much time we have left?

UNITED STATES ON VERGE OF BEING INTERNATIONAL DEBTOR

Mr. VOLCKER. Well, I can't tell you how much time because that depends upon a great many things, but I don't think it's sustainable from two directions. One is that the counterpart of that deficit is the pressures on particular industries that you just mentioned. I don't think it's sustainable that we run all our import-competing industries and exporting industries into the ground. Also, this flow rests upon confidence; I don't think you can assume that that confidence will be maintained indefinitely if we're building up our debts at the rate of $80 billion a year.

I noted in my statement, and I must say as a preliminary that our statistics on international capital flows are not necessarily the strongest statistical series in the world. They are hard to add up. But if you just take them at face value and take the recorded flows, we are on the verge of turning into an international debtor. I'm saying that this big and rich country, that typically, through the postwar period, has invested abroad, is now borrowing from abroad. We are borrowing at a rate of speed that in a couple of years will wipe out our whole positive international net investment position. If continued, it very obviously gets negative, and then it builds on itself. We now have a trade deficit this year of let's say $100 billion or so and a current account deficit of $80 billion or so; that $20 billion difference is partly net capital receipts from abroad, interest and dividends.

Senator PROXMIRE. That's been a tremendous turnaround in the investment account, isn't it?

Mr. VOLCKER. Yes, yes.

Senator PROXMIRE. That was very highly positive a few years ago.

Mr. VOLCKER. We built it up gradually over the years and blew it all in 3 years.

Senator PROXMIRE. This is the case as I see it for those who argue that you ought to take it a little easy in easing up on monetary policy.

The economy slowed steadily since the second quarter of 1983 when it grew at more than a 9-percent annual rate; the third quarter, 7 percent; the fourth quarter, 4 percent. We still have 9 million Americans out of work. Unemployment last month had indeed fallen sharply since the peak in November 1982, but it's still at 8 percent and 8 percent is higher than it's been for any year except one in the last 30 years, so historically it's very high.

We are operating, according to the Federal Reserve Board statistics, far below capacity. We have a glut of oil and other energy fuel. We still have gigantic food surpluses. Other commodities are also in big supply.

Where is the threat of inflation? If you should follow a policy of easing monetary policy over the next 2 or 3 years, why do you feel this would be inflationary?

Mr. VOLCKER. Let me make a couple of comments on the assumptions you made which I think are part of answering that question. You say the economy has slowed and domestic production has slowed, although the latest figures were quite favorable for January. But that slowing has to be interpreted in the light of what we

were just talking about. Demand has slowed very little; what's slowed is production. And the difference between those two numbers is the increasing trade deficit. More of the demand is spilling out abroad, not that the demand is down very much, which we affect, but more of it is spilling out abroad and that's not a very sustainable picture.

You say we are far below capacity. We have come up very rapidly on the capacity numbers, although I don't disagree that we are still below capacity.

Senator PROXMIRE. We're still about 80 percent.

Mr. VOLCKER. These are not the best figures in the world, but they're reasonably consistent over time. The capacity figure is running about 80 percent now, as I recall the latest numbers. It may have moved above that in January, but its in that neighborhood.

The figure that sticks in mind as kind of a norm for the area where we typically run into problems is 83 to 85 percent. It doesn't take very many months of rising industrial production to get up in that range. You see it now in some particular industries. We've got a paper industry that's operating full blast. The aluminum industry is operating at a very high level. Even in some areas of the steel industry they are——

Senator PROXMIRE. But in all those industries in the economy you still have a big labor surplus.

Mr. VOLCKER. I think, in general, in these areas there's a bigger labor supply because of efficiencies.

Senator PROXMIRE. And that constitutes about 70 percent of our cost, doesn't it? It's a big element.

Mr. VOLCKER. Yes, no question about that. I think we have got some room for capacity growth, but part of the reason that we're worried about the investment side is that we have not been growing much in capacity recently. Our net investment in business is very low historically now. Net investment after depreciation is low in postwar history. Investment has been rising pretty rapidly in 1983, but it's in very short-lived things. We hope that helps, but it's not the same as new factories.

You mentioned labor. Clearly, there's still a lot of unemployment. There's excessive unemployment. The wage performance has been good on the average, but typically this begins to be the stage of the cycle when you wonder about that. Profits are good. We had the indication of big General Motors profits. They look good, at least against recent experience. We do have old jobs, people who were laid off are pretty much back at work. There's still some excess labor capacity out there, but you wonder whether the bargaining climate will change.

I would be less concerned if we came off a long record of stability, but we've come off a long record of inflationary psychology and inflationary expectation. We expect prices to move up somewhat more rapidly, a little more rapidly in 1984 than in 1985.

The question is, can we create an environment in which that's a minor cyclical blip or do we create an environment in which people take that as an indication to go back to the inflationary habits of an earlier day? I don't think we know the answer to that fully yet. But put all these things together—that demand is still running quite rapidly, that we have a potential investment problem and ca-

pacity problem, that we have the question of whether the trend toward more stability will be psychologically embedded or not—and they make you cautious about the inflation outlook.

These all come down to a matter of judgment, and it's obviously important to debate, within a range, precisely the posture of monetary policy. But, in my mind, that debate does not range over an area so wide as opening up all the gates because there is just a lot of room to grow rapidly with no inflationary potential for a couple of years; that is not the way I see the picture.

You can make that finer judgment as to where all these things are balanced—and we try to do that to the best of our ability all the time—but it is a situation in which both the potential and the dangers are balanced, we think pretty evenly, or we wouldn't be following the policy we're following.

Senator PROXMIRE. I just have two more questions that the chairman has graciously permitted me to go ahead.

In your report to Congress last July you revealed that M_1 would merely be monitored rather than targeted. In your current report M_1 seems to be restored to its former status as a target rather than something to be monitored.

Was that a deliberate change by the Federal Open Market and, if so, what is the significance? Does the target mean you're going to be stronger in achieving that M_1 target?

Mr. VOLCKER. I think it's somewhere in between. I suppose what I would say is M_1 has been restored to probationary status. We think there is some question as to precisely how velocity will develop, but it looked more normal in the second half of last year. It did not look normal for a business expansion. It looked more normal in the sense that velocity was increasing but ordinarily we would expect it to increase even faster.

We were assuming, in setting this range that is obviously fairly wide, that velocity this year may look fairly normal for this stage of a business cycle, and we've allowed ourselves a little room on either side of that assumption.

If that assumption turns out not to be right, we obviously have to look at it again. What we said is that for the time being we don't put full weight on M_1 because we will evaluate it. If it doesn't seem to give us sensible answers relative to the other ends and relative to credit or relative to what's going on in the economy, we will have a certain skepticism about it. We expect it to give more sensible answers.

REVENUE SHARING WITH STATES

Senator PROXMIRE. My final question relates to the State and local surplus compared to our deficit. The chart following page 22 of your report shows that in 1983 State and local governments enjoyed a surplus of $15 billion in their operating budgets while the Federal Government had a deficit of nearly $200 billion. At the same time we've provided State and local governments with $4.5 billion in revenue sharing funds and are going to provide $5 billion a year over the next 5 years.

Does it make sense, in your judgment, that the Federal Government share its revenues when it has a huge budget deficit and State and local governments are enjoying comfortable surpluses?

Mr. VOLCKER. I used to think revenue sharing made a lot of sense. I must say that this budgetary picture casts some doubt upon it. I think you've got to justify revenue sharing on more structural considerations. Is it relatively easier over a long period of time for the Federal Government to raise revenues and avoid some of the competitiveness among the States? Is it just simply a structural difference between the ability of the Federal Government to raise money and the ability of State and local governments? I thought that was the case 20 years ago when I was in the Treasury and I was certainly a supporter of revenue sharing. I have to confess that current developments, at least at this point in time, don't bear out the feeling of a structural difference. I say that reluctantly, given my earlier views.

Senator PROXMIRE. So that could be a downpayment on the downpayment.

Mr. VOLCKER. That's one way of going about it. I don't know how happy it will make the mayors or Governors.

Senator PROXMIRE. It won't make them very happy.

Well, thank you very much, Mr. Chairman.

The CHAIRMAN. I didn't intend to get involved, but a former mayor cannot resist that one. Looking at the economic numbers you may have a case, but one of the justifications for Federal aid to States and localities is Federal requirements imposed on them. So I would only add that if you want to take away that, then you'd better also take away many of the mandated programs that we in the Congress said you must do, and many of those Federal funds are used for services that are required by the Federal Government to be performed that would not have been performed and did not exist. So there's that combination. You've got to have that caveat, Mr. Chairman.

Mr. VOLCKER. A perfect illustration of why I should not get into this kind of a conversation.

The CHAIRMAN. Senator Riegle has some additional questions he would like your response in writing.

[Response to Senator Riegle's written questions follows:]

Chairman Volcker's Responses to Senator Riegle's
Written Questions Submitted at the Hearing on 2/8/84

1. Trade Deficit

Q. Chairman Volcker, earlier this week you called attention to the risk posed by 2 deficits, the budget deficit and our international trade deficit. How do you propose we attack our international trade deficit when your policies, which have sustained the highest real rates of interest in our history, make American goods more expensive regardless of how efficiently they are produced, and foreign goods cheaper?

A. I have emphasized that the deficit in our external accounts -- more precisely, the current account deficit -- is related to the budget deficit, and have urged a serious attack on the budget deficit in the very near term.

The high real interest rates that you mention should be analyzed in the context of our monetary and fiscal policies taken together. While monetary policy plays an important role in encouraging the growth of demand in nominal terms, fiscal policy has a strong influence on the level of real interest rates as the budget deficit absorbs a larger or smaller proportion of private domestic savings. Thus, in 1984 the federal government is projected to spend in excess of its income more than 5 percent of the gross national product. High real interest rates are part of the process of inducing private U.S. residents and foreigners to increase their savings and reduce their spending, in order to finance, in real terms, the large excess of government spending over government revenue.

Looked at from the perspective of our international accounts, the current account deficit is a reflection of

this net lending to U.S. residents from abroad. To reduce the trade and current account deficits -- and thereby the net inflow of capital from abroad -- without reducing the budget deficit would require an increase in the excess of private domestic savings over private domestic investment, which would require additional upward pressure on real interest rates, other things equal. That is, the current account deficit (net capital inflow) has allowed the United States to finance its budget deficit at lower real interest rates than otherwise would have been the case. Interest-sensitive sectors of the U.S. economy have suffered less because exchange rate-sensitive sectors suffered more. If we want to escape from the continuation of high real interest rates and a larger trade deficit, we need, therefore, to attack the budget deficit.

2. Trade and DeIndustrialization

Q. By your own testimony (pages 21-22 of Monetary Policy Report), the dollar has appreciated by 50% since 1980 and the trade deficit has increased from an annual rate of about $45 billion in the fourth quarter of 1982 to a rate of about $75 billion in the fourth quarter of 1983.

Our country's exports are clearly suffering drastically and in the process effecting our industrial infrastructure and employment.

All signs point to continuing and significantly escalating trade deficits in the future. Some would say that these trade deficits are already leading to the deindustrialization of America.

What is your reaction and what is your opinion of the immediate consequences of these deficits on our industrial infrastructure, and if these deficits continue, what will the consequences be in the future?

Is the dollar overvalued with respect to other currencies -- such as the yen?

A. The widening of the U.S. trade deficit in 1983 was attributable to two main factors: the strong dollar, which made it more difficult for U.S. tradeable goods industries -- export industries and import-competing industries -- to compete with foreign producers; and the relative rapid expansion of the U.S. economy, which increased U.S. demand for tradeable goods. The rapid expansion of aggregate demand in the United States led to a rebound in U.S. manufacturing employment during 1983 to a level that is now about 5 percent below its level at the end of 1980, when the dollar was beginning to appreciate. The industrial production index for manufacturing has risen to nearly 5 percent above its level at the end of 1980.

Such evidence suggests that on average America's industrial sector to date has not suffered irreparable damage from the strong dollar, although it is equally clear that not all industries have shared equally in the economic expansion because of its unbalanced development. However, an unduly strong dollar, and the high real interest rates with which it might be associated, could pose serious risks for the structure of the American economy in the future -- for tradeable goods industries, for the housing sector, and for private investment expenditures throughout the economy. For reasons developed in my testimony, real progress toward reducing the budget deficit is needed to clear away these risks.

There is no uniformly-accepted way to measure how much the dollar may be "overvalued", or indeed on the concept of "over" or "under" valuation. One can try to make certain calculations, but the results should not be interpreted as indicating how exchange rates will or should move. Two popular calculations suggest that the dollar could be as much as 25 percent higher on average against the currencies of the other Group-of-Ten countries and Switzerland than might in the past have been regarded as "normal". The first calculation involves looking at the average level of real dollar exchange rates, or nominal exchange rates adjusted for national price levels, over the entire floating rate period since 1973. On this standard, which can be applied on a bilateral basis, the evidence is that the dollar is significantly less "overvalued" against the yen than it is against the major European currencies. A second calculation involves an assessment of the value of the dollar that would eliminate the U.S. current account deficit. This measure is much more difficult to apply since it requires an assessment of relative cyclical positions, as well as the outlook for wages and productivity in this country and abroad. It also implies a current account deficit of zero is appropriate.

More generally, the value of the dollar relative to other currencies will be influenced by the relative degree of

confidence in the economic and political outlook here and abroad.

3. Possibility of Renewed Recession

Q. What assurances, if any, can you give us that with the monetary targets you have outlined, and with existing deficits and loose fiscal policies, we will not be headed right back into a recession later this year or in 1985?

A. No one can offer absolute assurances about the future course of the economy. The experience of recent years has demonstrated that shocks arising from natural or political causes can be of such dimensions as to throw things out of kilter even if policies of unexceptionable character have been put in place before hand. And, given the lags and uncertainties associated with policy actions, the ability to offset such shocks as they occur is distinctly limited.

In the present circumstances, as we have indicated, it appears that the most probable pattern of developments for at least this year is continuation of good growth in real economic activity and only a slight -- largely cyclical -- pickup in the pace of inflation relative to what was experienced in 1983. A decline in activity does not seem likely, given the configuration of monetary and fiscal policies and basic trends in the economy, even though the composition of output and our foreign trade position is far from ideal. We have emphasized that the present trajectory of fiscal policy -- which implies continuing huge budget

deficits and mounting federal debt service burdens -- carries with it great risks of economic and financial dislocation and thus could at some point jeopardize the smooth, balanced expansion of the economy in the period ahead.

4. Election Year Politics

Q. Mr. Volcker, you are a man of high principle. In 1980 you refused to let the exigencies of an election year deter you from your adherence to your tight money and high interest rate principles. Will you show similar principle during the election year in 1984, particularly in light of the massive deficit which has been created since 1980?

A. I would not characterize our policies as being ones of tight money and high interest rates. But we believe that appropriate restraint on the expansion of money and credit is a necessary ingredient in shaping sustained, noninflationary economic growth and in restoring full employment and real prosperity -- and we have every intention of adhering to that principle. Action to remedy our deep structural budgetary imbalance is of the utmost urgency to provide greater assurance that the nation will achieve its longer range economic objectives.

5. Growth of Debt vs. Growth in GNP

Q. How would you compare the early stages of this recovery with other postwar recoveries? Specifically with respect to growth in GNP versus growth in debt?

A. During the past year, nominal GNP and the total debt of domestic nonfinancial sectors of the economy both grew 10-1/2

percent. This is something of a departure from the average pattern in the first years of earlier recoveries in the postwar period: debt typically has grown a couple of percentage points slower than GNP. The rapid growth of federal debt was particularly notable last year, as it ran at almost twice the pace of GNP expansion.

6. Lesser Developed Countries

Q. What effect will continually high interest rates have on the many developing countries with outstanding debt concentrated in dollars?

A. High interest rates, especially relative to the rate of inflation, are a great burden for developing countries with large external debts. A one percentage point increase in dollar interest rates raises interest payments due on the floating rate debt of major debtor countries by roughly $2-1/2 billion. These countries have been forced to generate large trade surpluses to cover a major part of interest payments due. Up to now, these surpluses have usually resulted from sharp cuts in imports and have been accompanied by substantial declines in economic activity.

Studies done by the Board staff and others indicate that, at interest rates near current levels, the debt burden of major debtor countries should decline gradually as economic growth in developed countries and the lagged affects of adjustment at home stimulate developing country exports. The danger, of course, is that these high interest rates may

not be compatible with continued economic recovery in developed countries.

Lowering real interest rates through higher U.S. inflation might temporarily help debtor countries. However, a burst of U.S. inflation would also likely lead ultimately to higher real interest rates and another recession, leaving these countries worse off than now. Lower real and nominal interest rates as a result of lower inflationary expectations and reduced pressures of federal budget deficits on U.S. and international credit markets would be of the most help to developing countries, through lower interest payments and through assuring sustainable, non-inflationary economic growth in developed countries.

7. Effects of Decline on Consumption Spending

Q. On page 2 of the Monetary Policy Report you say that "consumption spending . . . is likely to decelerate in the coming year." By how much and what sectors of the economy do you anticipate will be most directly effected?

A. I should emphasize that we generally foresee a slowing in the growth of real consumption spending, not a decline in the level. In 1983, there were very large gains in a number of components of consumption spending, especially in housing-related goods and in other durable goods such as autos. To some extent this reflected the marked decline in interest rates after mid-1982; there was as well an element of "pent-up demands" deferred during the recession; and soaring stock market wealth and further tax rate reduction gave further impetus to consumption outlays.

With the proportion of disposable income going to consumption already at an historically high level, and with the extraordinary factors I noted unlikely to be repeated, overall consumption spending in all probability will expand more moderately this year. Many of the industries that experienced dramatic increases in sales last year will enjoy good, and perhaps better, sales in 1984 (indeed, domestic auto sales have been in a distinct uptrend of late) -- but in many cases the gains last year were so sharp that they simply could not be compounded at those rates in 1984.

The CHAIRMAN. I just have one final question. When you came to Salt Lake City to testify before the first hearing on my financial restructuring legislation and also Senator Proxmire's bill, I asked you a question about monetary policy as well as fiscal policy in that hearing. So, I think it's only fair in view of the fact that this is about the monetary policy that I ask you a question about financial restructuring.

That would simply be if you would restate what you said in that Salt Lake hearing about the need for financial restructuring bills this year.

Mr VOLCKER. Certainly nothing has happened in that short intervening period to change my view that it is a matter of real urgency for Congress to express its view and tell us, the regulators, and the banks and the others what national policy is, in terms of sorting out what banks can do and what they can't do. I find—and there have been instances even in this last 2 or 3 weeks, since we were together in Salt Lake—that whenever an innovation takes place, we approve of some of it and some of it we don't, depending on our interpretation of what can or cannot be done and what congressional intent was under existing law. But one thing I know for sure is that existing law is just not fitted to the circumstances that we have to make decisions about, to put it very directly, and the system is being warped and changed—certainly changed and maybe, in fact, warped—by the mere fact that you have arbitrary limits under existing law. The system is evolving in ways that are going to be very hard to change and repair unless Congress gives us—and I'm not just talking about the regulators, but the country—a fresh mandate as to what public policy should be. I also do believe, as I said at Salt Lake City, that I think there is a hardcore of issues upon which a high degree of consensus has already been reached. There are some things, clearly, when consensus has not been reached, but I think you have something upon which to build, and the opportunity for constructive legislation seems to me to be here this year.

I don't argue it won't be without controversy, but I do argue that the core of the legislation, while it may not have a perfect consensus, has a wide degree of support among affected financial institutions, and others.

The CHAIRMAN. Well, I was certain your answer had not changed. It was just that I candidly did not expect too many people to read the hearing record so I wanted you to repeat it again.

Mr. VOLCKER. I think it is very important. It doesn't match, I suppose, the budgetary deficit and monetary policy in terms of short-run significance, but it is a very significant matter in terms of the structure. I'm afraid inaction is a decision, because the structure is going to be warped without it.

The CHAIRMAN. Thank you very much, Mr. Chairman.

The committee is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

31-490 O—84——10

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1984

THURSDAY, FEBRUARY 9, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, Humphrey, and Proxmire.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This is the second day of hearings conducted on monetary policy. Yesterday we had before us the Chairman of the Federal Reserve Board.

Today we are honored to have the Honorable Beryl Sprinkel, Under Secretary for Monetary Affairs, Department of the Treasury; he will be followed by the Honorable Martin Feldstein; then we will have a panel with Dr. Robert Parry and Dr. Allan Meltzer.

Secretary Sprinkel, we are happy to have you with us today and if you would like to proceed with your testimony.

STATEMENT OF BERYL SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SPRINKEL. Thank you.

[Complete statement follows:]

For Release Upon Delivery
Expected at 9:30 a.m.

STATEMENT BY BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C.

Thursday, February 9, 1984

Chairman Garn, Senator Proxmire, distinguished Members of the Committee, it is as always a pleasure to be here to represent the Administration's views on current and prospective monetary policy. I would like to begin this morning by making some comments about the budget deficit because I know it is the economic issue that is currently dominating most people's minds. Then I will turn to monetary policy -- which is, of course, the subject and purpose of these hearings.

The difficult problem of the budget deficit must be addressed and resolved. As President Reagan has indicated, the projected size of budget deficits are unacceptably high, regardless of whose forecast is used. While individuals may not agree on the precise quantitative effects of budget deficits, the timing of those effects or the best approach to reducing deficits, everyone recognizes that large prospective budget deficits have serious, adverse implications for future capital formation, productivity and economic growth.

Even if one accepts the argument that there is a clear and verifiable connection between large deficits and rising interest

rates, there is no reason for current and projected deficits to cause additional increases in interest rates. The projected size of future budget deficits has already been largely discounted by the financial markets and those expectations are incorporated into the current level of long-term interest rates.

With respect to monetary policy, however, the critical concern is that we not allow monetary policy to stray off course because of concerns about the budget deficit. The budget deficit is a fiscal problem, not a monetary policy problem. The present and future goal of monetary policy should be to provide stable and moderate money growth at a rate that is consistent with both price stability and sustainable real economic growth. That is as true with record-high deficits as it would be if the budget were balanced.

A fundamental fear in the financial markets is that large deficits will lead to inflationary money growth as the Federal Reserve "monetizes" the debt. That fear, and the general uncertainty about the budget situation, heightens the need for an announced commitment to noninflationary monetary policy that is backed up by appropriate monetary actions.

The Progress In Reducing Inflation

A growing number of economists -- and I think the public in general to an increasing extent -- now recognize that inflation is fundamentally a monetary phenomenon. A necessary prerequisite for price stability is that money growth be constrained to a noninflationary pace over the long run. The relationship between money growth and inflation is a long-term one; money

growth affects the rate of inflation with a lag of 1-1/2 to 2 years. It is therefore the long-term or trend rate of money growth that determines the rate of inflation. Chart 1 illustrates this relationship since the early 1960's; here the year-over-year growth rate of M1 is plotted with a two-year lag, along with annual changes in the GNP deflator. As can be seen in the chart, not only are fluctuations in inflation closely correlated with lagged changes in the long-term rate of money growth, the secular rise in inflation over the past two decades corresponds to a general upward drift in money growth.

But much of the public and media discussions of the causes of inflation focus on the short run and have therefore, at least until recently, often not emphasized the role of money growth as the root cause of inflation. When we focus on month-to-month movements in price indices, it is always possible to identify the particular items that contributed to a given rise in a composite price index. Such changes in relative prices -- the prices of specific goods or categories of goods relative to other goods -- should not be confused with generalized inflation.

During the 1970's, the tendency to confuse relative price changes with inflation provided a series of anecdotal explanations or justifications for a rising inflation rate. Each short-run increase in the price indices was attributed to increased energy costs, increased food prices, rising wage rates or some other development; such analysis implied, directly or indirectly, that the general rise in inflation was somehow

beyond our control because it was the sum-total result of OPEC actions, weather changes and other uncontrollable events. Such incomplete analysis contributed importantly, I believe, to the public's gradual acquiescence -- or at least acceptance -- of an inflation which rose from an annual average of less than 1.3% during the 1961-65 period to an annual average of nearly 9% in the five years ending in 1980. Blaming the acceleration of inflation in the 1970's on uncontrollable events such as oil embargoes and drought is akin to identifying as the cause of Washington's hot summer weather, the rise of the mercury in the thermometer.

History has repeatedly demonstrated that inflation is not something that is imposed upon us by mysterious and uncontrollable forces; it is inevitably the result of excessive money growth. It is no accident that while inflation rose secularly, money growth increased from an annual average of 3.5% in the 1961-65 period to an annual average of 7.4% in the five years ending in 1980. Just as excessive money growth leads to rise in the inflation rate, price stability, conversely is the inevitable result of noninflationary money growth.

Price stability does not mean there are no changes in the prices of specific goods or services. To the contrary, relative price changes are the essence of the market system; it is through increases or decreases in individual prices that changes in demand or supply conditions are resolved by the market. But one-time changes in relative prices (even though they may be substantial and may affect the price indices over a period

of many months or even years) do not provide an explanation or justification for ongoing -- let alone accelerating -- inflation like that of the late 1960's and the 1970's. Only unsound and inflationary monetary policy can convert increases in relative prices of specific goods into generalized, ongoing inflation.

Just as our short-run myopia about economic events tended to de-sensitize us to a rising inflation rate in the 1970's, I think we now tend to understate or "under-recognize" just how far we have come in reducing inflation in a relatively short period. In just three years the annual increase in the CPI has fallen from 13.5% in 1980 to 3.3% in 1983.

Three years ago, inflation had become a seemingly-permanent aspect of our economic lives. For example, it is interesting to compare inflation rates in the past three years with those projected by the Carter Administration in the 1981 Annual Report of the Council of Economic Advisers. On a fourth quarter-to-fourth quarter basis, those projections were 12.6%, 9.6%, and 8.2%, for 1981, 1982 and 1983, respectively, compared to actual results of 9.6%, 4.5%, and 3.3%. Over the three years, that amounts cumulatively to a 13% slower rise in prices than was anticipated in 1981. I know of no economic forecastor who foresaw the rapid decline in inflation and few economists would have seriously believed that such remarkable progress was possible, let alone probable.

There are those who contend that the price we have paid for the progress on inflation -- in terms of a short-run loss

of jobs and output -- has been too great. But it is not relevant to compare the economic dislocation associated with reducing inflation to some ideal of economic performance that includes continued high real growth and low unemployment. The relevant comparison is between the effects of the anti-inflationary monetary policy that began in 1981 and the likely outcome of its alternative -- continued inflationary money growth. It is highly unlikely that a period of declining output and employment could have been avoided by taking no action against an accelerating inflation rate. Failing to deal effectively with rising inflation -- that is, an attempt to provide continued economic stimulus through inflationary money growth -- would likely also have resulted in a recession, as interest rates rose with inflation and inflationary expectations.

Historical experience is not consistent with the view that a recession would have been avoided by postponing actions to control inflation. The notion that inflation can be permanently maintained at some stable rate, which becomes harmless once the public adjusts to it, is a myth. If the underlying goal of monetary policy is not price stability, then the inflation rate and interest rates will ratchet upward over time and the problem of unemployment will grow worse.

The length and depth of the 1981-82 recession provides a valuable lesson for the American public: once inflation and inflationary expectations become embedded, returning an economy to a noninflationary path is an extremely difficult and a potentially costly task. This is a principle that has been

demonstrated to us in the past, most recently in the 1973-75 recession; in that period money growth was slowed substantially and inflation and interest rates fell. We unfortunately did not learn from that experience; the progress on inflation was soon thrown away when money growth was allowed to reaccelerate to highly inflationary rates for the next four years.

The severity of the last recession should lead us not to the conclusion that the process of restoring price stability is too costly, but that it is so costly that we cannot afford to go through it again. The secular rise in inflation since the 1960's had pervasive, harmful effects on economic incentives and performance; there should be no debate about the far-reaching, beneficial effects of permanently controlling inflation.

The Importance of a Long-Run Commitment to Price Stability

Moving an economy from an inflationary path to a noninflationary one requires a profound readjustment of people's behavior and thinking. By the late 1970's there were many signs of the effects of inflation on our economic behavior. A "buy-now-before-the-price-rises" psychology had become prevalent. Wage-earners were demanding large wage increases on the belief that they were needed just to "stay even" with inflation. Borrowers were willing to borrow money at record-high interest rates because they believed that they could repay the debt in depreciated dollars. For many households, saving consisted only of inflation-related increases in the value of real estate holdings. These are all examples of inflation-induced behavior

that had to be altered, and must continue to be altered, if permanent victory over inflation is to be achieved.

The economic dislocation -- lost jobs and output -- associated with reducing inflation occurs when such public behavior collides with a noninflationary monetary policy. That is, once money growth is reduced to a noninflationary pace, there is insufficient money in the economy to finance continued inflationary behavior as well as real, productive economic activity. Even though money growth is ample to support real economic activity, it will be insufficient to support a level of nominal economic activity that presumes a continued high rate of inflation. Something has to give and, in the short run, it is typically real economic growth. However, the faster the public adjusts its behavior to a noninflationary environment, the shorter and the smaller will be the real economic dislocation.

Thus an important aspect of a policy designed to reduce inflation is that the public be convinced of the Federal Reserve's determination to make it succeed. Federal Reserve officials have repeatedly reaffirmed their commitment to a policy of gradually reducing money growth to a rate consistent with price stability. Recognizing the need for the public to believe in that commitment, this Administration has always publicly endorsed the Federal Reserve's money growth target ranges and has continually urged the Fed to achieve those targets. While we have been critical of the Fed's actual policy at particular times -- primarily when money growth strayed well-above or well-below its prescribed growth range

-- our support for their basic, noninflationary policy has never faltered and we have tried to convey that commitment to the Federal Reserve, the Congress and the public.

But well-meaning statements of intentions from public officials are not enough. It is important that money growth targets be achieved so that the Federal Reserve's actions also convey their long-run commitment to a noninflationary policy. In addition to the monetary discipline they are designed to impose, money growth targets that are consistently achieved can help assure the public -- and in particular financial market participants -- that we will not revert to inflationary policies.

The money growth targets announced by the Federal Reserve this week are appropriate and consistent with a continued decline in inflation. We urge the Federal Reserve to take the policy actions needed to achieve those targets. In its report to the Congress, the Federal Reserve has indicated that "growth around the mid-point of the range (for M1) would appear appropriate, on the assumption of relatively normal velocity growth..." (Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress, February 7, 1984, pgs. 8-9). That judgement is also, I believe, an appropriate one, and the mid-point range for M1 should be the goal of Federal Reserve policy actions during 1984, unless convincing evidence emerges that institutional or other changes have altered the relation between money growth and economic activity and a

recalibration of our monetary goals is justifiable. In addition, I urge the Congress to voice their support for the Federal Reserve's stated policy and to urge the Federal Reserve to achieve the target ranges, so that all branches of the government would send a clear message to the public that our collective resolve to re-establish price stability has not waivered.

In February 1980, the Monetary Policy report of this Committee, pursuant to the Humphrey-Hawkins Act, contained a number of important recommendations about monetary policy. One in particular, I believe, deserves reiteration. That recommendation was that the Federal Reserve set multi-year money growth targets. This would be an excellent step toward a clearer enunciation of our long-term goals and expectations for price stability which could help reduce the skepticism that is now associated with long-run monetary control.

Some would argue that such long-term money targets would reduce the Fed's flexibility. The setting of longer term money targets would not, however, reduce the Fed's flexibility to deal with unforeseen developments or institutional changes. Such contingencies can be met within the context of a long-term commitment of monetary policy intentions. There is no inconsistency between setting and following monetary targets and maintaining basic flexibility to respond to changing institutions or developments. If changes in monetary targets can be justified by the facts, those changes can be made and explained to the public, with no deleterious implications for long-run monetary discipline.

The Problem of Monetary Variability

The importance of public confidence in anti-inflationary policy is one of the bases for the Administration's concern about the volatility of money growth. When the Federal Reserve allows money growth to accelerate to a rapid pace for a period of many months or several quarters, skepticism increases that a noninflationary policy will be adhered to over the long run. Whether or not such a period of more rapid money growth represents an intentional shift in the Federal Reserve's long-run policy stance, it inevitably raises the uncertainty surrounding any forecast of future inflation. Such uncertainty, together with expected future inflation, is an important determinant of interest rates, and that is why volatile and unpredictable money growth adds to the level of nominal interest rates.

While interest rates remain higher than most of us would prefer, it is important to recognize that we have also made important progress in bringing rates down in the past three years. Chart 2 shows the paths of a representative short-term and a long-term interest rate for the period since 1981. While their declining path has been uneven -- as is typically the case -- short-term rates are now 800-900 basis points below their 1980-81 peaks and long rates have fallen about 250-300 basis points from their peak levels.

There is room for interest rates to fall farther as inflationary expectations continue to adjust downward. Nominal interest rates remain high relative to current inflation rates.

If, for example, the current inflation rate is subtracted from today's long-term rates in the 11-1/2 - 12% range, the result is the 7-8% rate that is frequently labelled the high "real" interest rate. The correct calculation of a real interest rate, however, is to deduct expected inflation, and therefore the resulting measure of the real rate depends critically on how expected inflation is measured. While expectations of inflation have clearly declined in recent years, it is also clear that they have not declined as much as has actual inflation. The latest Blue Chip survey of economic forecastors shows that they expect inflation to average 5.5% over the 1985-89 period.

Uncertainty about future inflation raises the risk associated with any commitment of funds, particularly over a long period of time. This is commonly referred to as the risk premium built into the level of interest rates. It exists despite the actual decline in inflation, because investors remain highly uncertain that inflation will remain low for the full life of financial assets. An important source of that uncertainty is volatile money growth; with each upswing in money growth, investors become again wary that noninflationary monetary policy is not a permanent part of our macroeconomic policies.

Empirical research indicates that during 1980-81, monetary volatility has added 2-3 percentage points to the level of interest rates. This effect is illustrated in Chart 3 which relates a statistical measure of monetary volatility, the

degree of difficulty associated with forecasting money growth, to a short-term and a long-term interest rate.

In addition to the implications for interest rates, variability in money growth induces corresponding fluctuations in real economic activity. In the short run, money growth is closely correlated with real GNP growth, even though over the long run money growth determines inflation. This short-term effect of changes in money growth on real GNP is illustrated since 1979 in Chart 4. As can be seen in the chart, sharp fluctuations in money growth are closely associated with similar fluctuations in real GNP growth.

It is this short-run correlation between money and real activity that makes the monetary deceleration since last summer particularly troublesome. The recent revisions in the M1 data result in a more moderate deceleration than was originally recorded; nevertheless, money growth slowed substantially during the last half of 1983. This slowdown in money growth subjects the real economy to the risk of an unacceptable slowdown or downturn in the first half of 1984. That threat continues, and grows, the longer money growth is constrained to a slow rate.

Because of the close relationship in the short run between money growth and real GNP, the Administration has repeatedly urged the Federal Reserve to provide for a smoother, more stable and predictable path of money growth. This recommendation does not mean that we expect the Federal Reserve to achieve precise

week-to-week or month-to-month monetary control; technical problems preclude such short-term precision.

Relatively smooth and stable money growth on a quarterly basis is, however, technically achievable; Federal Reserve staff has estimated that quarterly M1 growth could be controlled within a range of ±1%. That result would be a great improvement over the recent record and would have two important benefits. First, it would dampen the policy-induced fluctuations in real economic activity. Second, it would reduce the uncertainty about long-run monetary control and thereby help hasten the downward adjustment of inflationary expectations and interest rates.

Improving Monetary Control

I am not optimistic, however, that money growth will become more stable as long as the Federal Reserve uses its current operating procedure. Those who believe in the importance of moderate and predictable money growth have long advocated some technical changes in the way the Fed operates on a day-to-day or week-to-week basis in order to improve the precision of monetary control.

The Federal Reserve has adopted one of those recommendations by reinstating contemporaneous reserve requirements in place of the system of lagged reserve requirements. It has been argued that lagged reserve requirements reduced the precision of short-run monetary control by causing a two-week lag between deposit creation and a bank's need to hold added required reserves. The new reserve requirement regime essentially

31-490 O—84——11

reduces that lag to two days and could help reduce the short-term slippage in money stock control. It is unlikely, however, that much improvement in monetary control will materialize, if the Federal Reserve does not also adopt other technical changes that are needed to complement the new contemporaneous reserve system: focusing day-to-day open market operations on controlling a reserve aggregate (or the monetary base), and instituting a market-related, penalty discount rate.

Since late 1982, the day-to-day operating procedures of the Federal Reserve have been designed to provide a prescribed degree of restraint or ease in money market conditions and bank reserve positions. This is functionally equivalent to a policy of targeting the Federal funds rate, which was the Fed's operating procedure during the 1970's. Since the relationship between interest rates and money growth is not a dependable or predictable one (particularly as economic conditions vary), targeting the Federal funds rate generally yields very imprecise control of the monetary aggregates. This was recognized by the Federal Reserve when it abandoned that control procedure in 1979.

Because there is no reliable relation between money growth and interest rates on which the Fed can depend, an operating technique that focuses on controlling interest rates by definition introduces large errors into the money growth path; as long as it is an interest rate that is deliberately controlled by the Fed, money growth is largely residual or accidental. In addition, there is no systematic or automatic procedure by which

errors in short-run money growth are corrected. Historically, short-run deviations or errors in money growth have not been offset, but have been allowed to accumulate over time. Short-term deviations away from the target path -- which in and of themselves have no particular economic meaning or consequence -- therefore become prolonged periods of too-rapid or too-slow money growth -- which do have very real economic consequences. The result is not a policy that minimizes the risk to economic performance; instead, the economy is unnecessarily subjected to the possibility of policy-related fluctuations in real economic activity.

The discount rate, as it is currently administered by the Federal Reserve, also introduces a significant margin-of-error in money stock control. Changes in the discount rate typically lag behind changes in market interest rates. Banks' incentives to borrow reserves at the Fed depend directly on the difference between the discount rate and market interest rates. Changes in market rates, with a sluggish or unchanged discount rate, therefore alter banks' incentives to borrow reserves. As a consequence, an important part of reserve growth (or growth of the monetary base) slips outside direct control of the Federal Reserve.

In my judgement -- and that of many experts -- the precision of monetary control would be improved if the Federal Reserve would focus its short-run operations directly on controlling some monetary aggregate, ideally the monetary base (or some aggregate measure of bank reserves) and if the discount rate

were tied to a market interest rate. Evidence indicates that the result would be a smoother, more predictable path of money growth which would reduce uncertainty about future inflation and minimize the policy-related disturbances in real economic activity.

Conclusion

The uncertainty that clouds the outlook in the financial markets is well summed up by a recent statement in Bondweek. It reads, "Though dealers say investors are cash rich, they add that rates aren't high enough to compensate retail buyers for their uncertainty about economic performance and Federal Reserve policy." (Bondweek, January 30, 1984, pg. 1)

I do not mean to imply that monetary policy is currently the source of all economic uncertainty. Clearly, progress in resolving the budget deficit situation would help reduce the uncertainty about prospective economic performance and could improve conditions in the financial markets. But our unresolved fiscal issues heighten the need for a well-articulated and predictable, noninflationary monetary policy. A fundamental fear of financial market participants is that prudent monetary control will be abandoned in the future as the Federal Reserve "monetizes" large budget deficits. The best way to allay those fears is for the Federal Reserve to establish and achieve noninflationary money growth targets and for the rest of us -- the Administration as well as the Congress -- to support a Federal Reserve policy of long-run, noninflationary monetary control.

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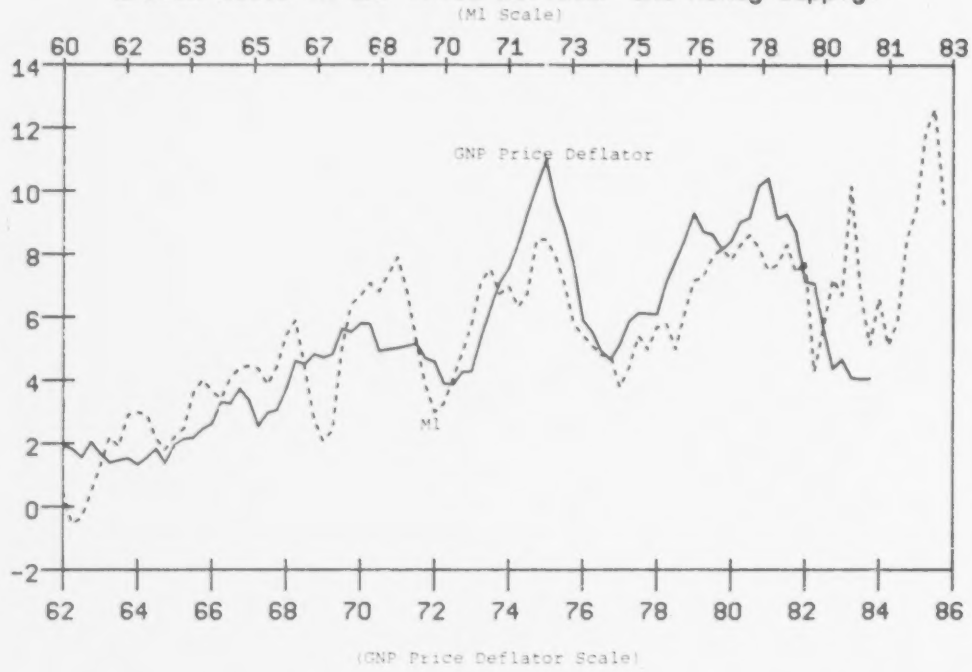
MONEY LEADS INFLATION BY TWO YEARS

Growth Rates in GNP Price Deflator and Money Supply*



*Quarterly figures. Growth measured from one year earlier.

CHART 1

CHART 2

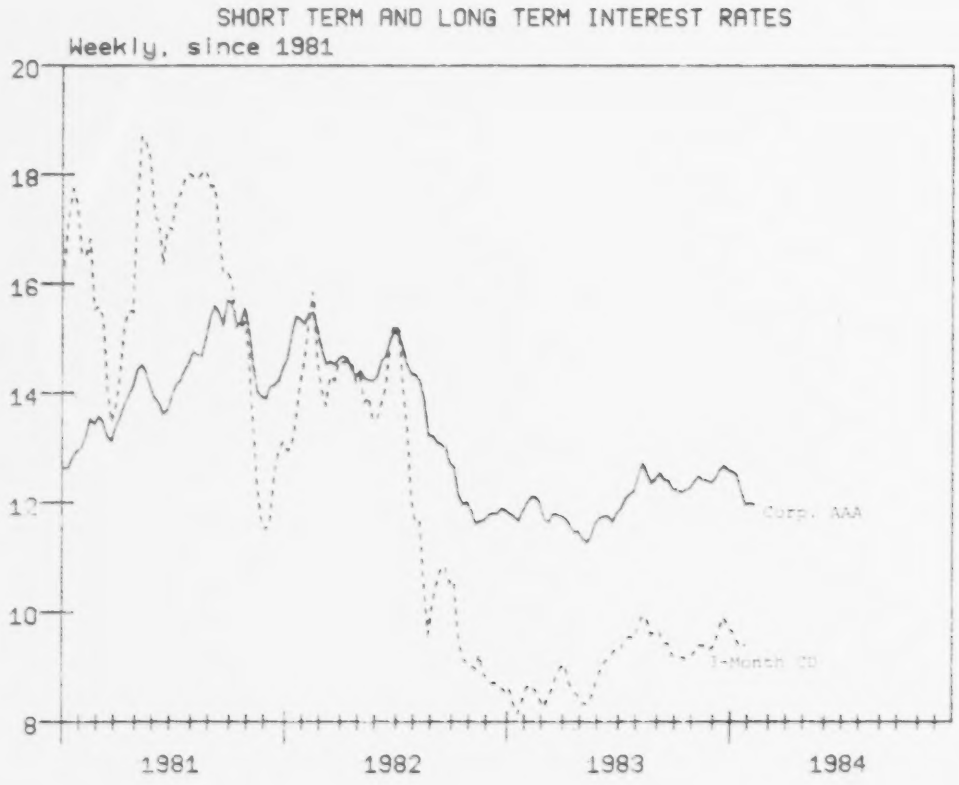
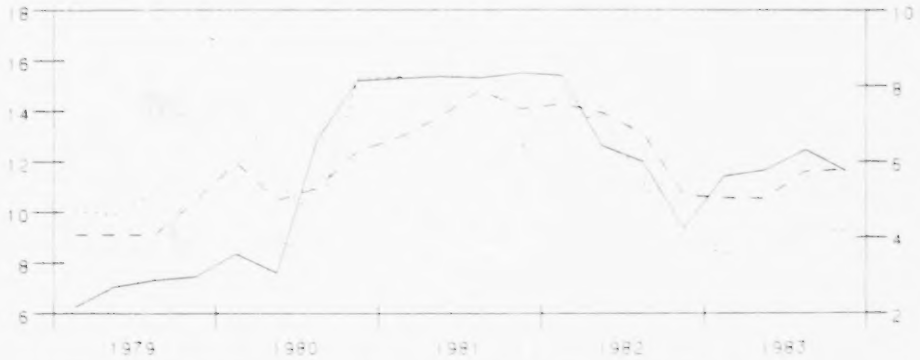


CHART 2

CHART 3

COMPARATIVE BEHAVIOR OF INTEREST RATES AND
MONETARY VOLATILITY*
DOT--90 DAY RATE DASH--10 YEAR RATE
LINE--MONETARY VOLATILITY

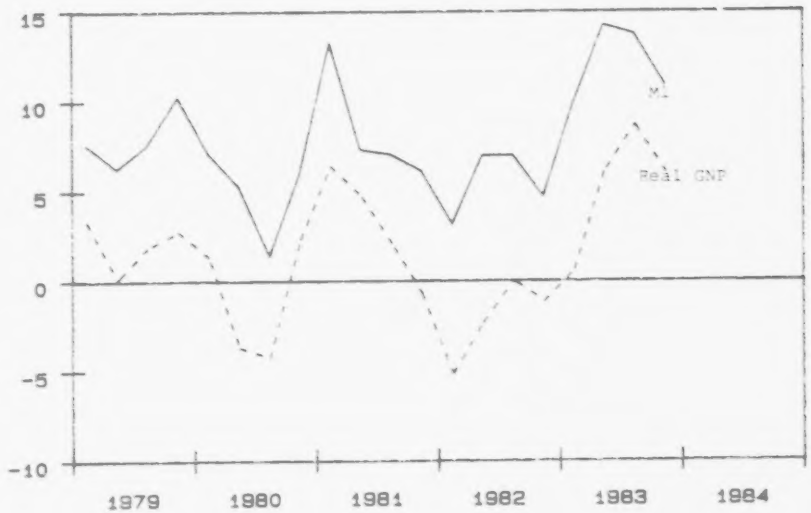


*MONETARY VOLATILITY IS A MEASURE OF THE DEGREE OF
DIFFICULTY IN FORECASTING MONEY GROWTH
AS DESCRIBED IN A STUDY BY MASCARO-MELTZER
INTEREST RATES IN A R SKY WORLD
JOURNAL OF MONETARY ECONOMICS, NOVEMBER 1983
INTEREST RATES ARE QUARTERLY AVERAGES

CHART 3

CORRELATION BETWEEN MONEY GROWTH AND REAL GNP

(Semiannual rate of growth in M1 and real GNP)



*Money growth is plotted with a one quarter lag.

CHART 4

The CHAIRMAN. Thank you, Mr. Secretary.

Yesterday Chairman Volcker said that the slowdown in money growth during the second half of last year was the consequence of an upturn in velocity. Would you comment on his statement?

Mr. SPRINKEL. Was a consequence of an upturn in velocity in the last half?

The CHAIRMAN. Right.

REASON FOR SLOWDOWN IN MONEY GROWTH

Mr. SPRINKEL. In the earlier money series reported by the Fed, there was a significant rise in velocity in the last half of the year. However, as you know, they have just revised the series and much of the velocity increase suddenly disappeared. So I would have to see the statement within context; but it seems to me a much clearer statement of what happened was that there was a very sharp contraction in the growth of adjusted reserves and the monetary base.

For example, I will read you some numbers. With respect to adjusted reserves in the first quarter of last year, they rose at an annual rate of 11.5 percent; in the second quarter, at 10.4 percent; the third quarter, 3.8 percent; the fourth quarter, 4.5 percent. If you prefer the monetary base, the same pattern is evident—11.4, 10.9, 6.8, 8 percent.

So the real reason, in my opinion, for the slowdown in monetary growth in the last half of last year was that open market operations were conducted in a way that reserve growth slowed substantially. There is no way the system can expand the money supply with a sharp contraction in reserve growth.

The CHAIRMAN. Again, you repeated what you said in your statement that due to the slowdown in monetary growth in the last half of 1983 that you expect a slowdown in the economy in the first half of 1984.

Mr. SPRINKEL. Yes, sir.

The CHAIRMAN. Now other economists argue that the economy is slow because this is natural and in fact desirable in the second year of expansion, that we were growing too rapidly, that inflationary pressures and the fact that there was a slowdown is not only natural and but also desirable.

Mr. SPRINKEL. I agree with both statements. It is indeed to be hoped that the rates of rise in total spending and real output will not soar at the rates that were evident in the early part of last year when we were in the very early stage of the recovery.

The rate of rise in economic activity, of course, did slow throughout 1983 and in the fourth quarter, as I remember, was rising at about a 4.5-percent rate.

The risk is that either growth could become negative—I don't know that that will happen—or that the rate of growth will be substantially below our real capacity for growth. That would mean, unfortunately, rising, not declining, unemployment. We have made enormous progress in getting the unemployment rate down and I do not want to see it reversed.

The CHAIRMAN. Mr. Secretary, I'm troubled by a general theme of your testimony and I don't mean that personally because I'm

troubled by almost all the testimony that I've heard lately, or the questions from some of my colleagues or the public comments from those who are not members of this committee, and that is that it seems obligatory that everybody comes here and decries the deficit and how they are damaging and we simply must do something about them. But then it ends and everybody seems, some much more than others, some more blatantly than others, to shift it to monetary policy. And this is true of the administration; it's true of Secretary Regan; it's true of your testimony. It was true yesterday in most of the lines of questioning.

I'm not a trained economist, but just since I have been in the U.S. Senate in 9 years, the first year I was here, President Ford's budget recommendation was for $295 billion and we passed $318 billion. So in a relatively brief period of time I have been here to see budgets of $300, $400, $500, $600, $700, $800, and now $900 billion, $1.4 trillion of accumulated national debt, $130 billion of interest on the national debt which is in excess of what John Kennedy ran the whole country for and defended for just 22 years ago, and although everybody touched on it, it is basically lip services, that somehow that doesn't have anything to do with it and if we could just make the Fed have a stable monetary growth that somehow that's the big answer to inflation, and interest rates, and everything else.

Now that's what I'm hearing day after day after day and I know you, Secretary Regan, the administration, and Congress all decry the deficit, and then we all seem to get the shift, whether it's subtle or whether it's really overt for political reasons, that somehow this enormous increase in spending—look at U.S. News and World Report put it in graphics and when they put it in graphics and look at the last several years and those big blocks of red and this accumulated deficit, I just have to take the opposite view that certainly monetary policy has something to do with it, but we are essentially trying to make somebody else the scapegoat for the problems of the executive and legislative branch, everybody else, and ourselves.

We've got testimony later—I was reading the testimony of one of our private sector witnesses and he's going to have a recommendation that Congress require the Fed to have certain targets and if they miss them by 1 percent they are required to submit their resignations to the President.

Now if we placed those kind of standards on Congress for our missing estimates in the budget, nobody would be here and we would have no Congress. It would turn over instantly.

So maybe it would be a good idea to apply it to Congress, but I'm really troubled by all of this testimony. And maybe that is not your intent, but that's the way I continually take it from almost everything I hear is that none of us are responsible. It's just that damned Fed. I can't buy that argument. I just cannot buy it in light of the evidence of the fiscal performance of Congress and the recommendations of several administrations.

Mr. SPRINKEL. I have been very careful, in this testimony, public statements, and prior testimony, to avoid scapegoating the Fed. I have given them public commendations, as I did again this morning, for getting the rate of growth in money down. I explicitly

stated that even if we had a balanced budget we should have stable, moderate growth in the money supply. If we have a massive deficit, which is what we have, we should still have stable growth in money. That is all that I am asking.

That doesn't solve the fiscal problem. There is a relation between the two. There are risks associated with large deficits; they are that—not automatically—but it could through political pressure or otherwise, lead to inappropriate monetary policy. That need not be, but it could happen. These hearings, of course, as you suggested to me, are on monetary policy. I certainly have strong views about getting that deficit down. It creates very real problems. They have to do with capital formation. It has to do with productivity improvement. It has to do with improved standards of living. It has to do with growth in jobs into the future. It is extremely important that we permit that capital formation pattern to proceed without the Government absorbing a high percent of total credit, and that is a real problem.

But the problem is compounded if at the time we are unable to exert fiscal discipline, we at the same time have extremely volatile monetary policy. All that I am saying is that we need both. From a monetary policy point of view, we need a slow, predictable rate of growth that people have confidence in, so we can get interest rates down.

The CHAIRMAN. I don't disagree with you, but I don't think it is possible for the Fed to be able to even predict monetary growth accurately enough—I know we have talked in the past about going to contemporaneous accounting rather than lagged and improving some of the mechanisms and getting away from weekly reporting which everybody agrees is not accurate and all of that. But how can you expect that to be done with the irrational behavior of fiscal policy in this country? They have to go together. They have to work together and we have had the Fed the only actor in town for many years attempting to do what you're suggesting they do and admittedly sometimes not very well, but our performance is unbroken. Nobody can say that we in Congress on the fiscal policy have even come close to any stability or reasonableness or any commonsense at all.

That's where I get; we're trying to scapegoat it over here. I almost wish, to prove my point, that we could find an Open Market Committee who was so perfect that they could run the type of growth that everybody wants to be run, do it perfectly, and, boy, then would we highlight what is going on over here or what is not going on over here.

Mr. SPRINKEL. I would be glad to settle for what the technical experts in the Federal Reserve System say is doable, that is, they will hit their target within plus or minus 1 percent on average per quarter. That would be marvelous. That's not perfect, but it's very good and much better than what they have done in the past.

The CHAIRMAN. Senator Proxmire.

DISCUSSION ON SECRETARY SPRINKEL'S CHARTS

Senator PROXMIRE. Secretary Sprinkel, you're an ideal witness because you've had a lot of practical experience as a banker; you

taught at the University of Chicago, you're recognized all over the country as one of the outstanding monetary experts in the country, and you've had solid experience in Government with the Treasury Department for the last 3 years. So I certainly welcome you as an expert on this and I'm intrigued by the charts you give us showing the relationship between the change in the money supply and growth in prices.

It's an astonishingly close match on growth and it's reasonably close on prices. You say there's a 2-year lag, I take it, between a change in the money supply and the corresponding change in prices; is that right?

Mr. SPRINKEL. Yes, sir. Most of the evidence says 1½ years to 2 years.

Senator PROXMIRE. And you see a 3-month lag in the relationship between the change in the money supply and economic growth?

Mr. SPRINKEL. If you use a 6-month average of money growth, you come out with about a 3-month lag. But from the time the first action is taken, it is something on the order of 6 to 9 months before a change in money has an important bearing on real output.

Senator PROXMIRE. All right, 6 to 9 months. Now what effect would it have on unemployment inasmuch as employment is a lagging indicator and inasmuch as employers normally don't hire or lay off until they have to. Would you say there might be a 9- to 12-month spread or something like that?

Mr. SPRINKEL. Maybe even less. It's true that when orders go down for whatever reason they don't immediately lay people off and there might be a little additional lag; but there's a fairly close relation to total output as measured by either real GNP or initial production and employment.

Senator PROXMIRE. Well, this has fascinating political implications.

Mr. SPRINKEL. Yes.

Senator PROXMIRE. Because it means that Paul Volcker and the Federal Reserve Board can now get off the hot seat as far as the 1984 elections are concerned, that's it. Everything is in the bag because the growth you say is 6 to 9 months and unemployment will be closer to 9 probably, prices at 2 years. So whatever policy they follow in March isn't going to elect or defeat President Reagan in the election. Is that right?

Mr. SPRINKEL. Sir, that's your conclusion.

Senator PROXMIRE. Well, I'm arguing on the basis of what you tell us here. As far as the budget is concerned, it's certainly your conclusion.

Mr. SPRINKEL. What I hope I conveyed to you was that the monetary path in the immediate future now, tomorrow, the next few months, is critically important as to whether we have a severe downturn in the economic activity or a modest one. To me that means jobs and, hence, we want to continue to see what has happened in December and January: growth in money of moderate proportion.

Senator PROXMIRE. Secretary Sprinkel, I agree with that. All I'm saying is that the timing that you have given us this morning shows a lag and——

Mr. SPRINKEL. That's right.

Senator PROXMIRE. And then you've just changed horses by saying from the time the Open Market Committee makes a decision until the time that is felt in economic growth and employment and the time it's felt in prices is a considerable number of months, in the case of growth, from 6 to 9, in the case of prices, it's 2 years.

Mr. SPRINKEL. Yes, sir. We might be talking about the effect on the late second or third quarter if we continue to get more money starting today.

Senator PROXMIRE. Now, as I look at this first chart of yours on prices, it appears that there was a big increase in the supply of money in 1982 and therefore that should result in some sharp increase in prices in 1984 if this holds; is that right?

Mr. SPRINKEL. There was a very substantial increase in the rate of growth in money starting approximately August, if I remember correctly, of 1982 and extending through the spring of 1983, perhaps as late as June. Raising the average rate of money growth for the past 2 years, as indicated by this chart, does imply some increase in the inflation rate in 1984 and our official projections, of course, allow for that.

Senator PROXMIRE. They allow for as much of an increase as is indicated here? This is a very, very big increase in 1982.

Mr. SPRINKEL. You'll notice from the most recent numbers that the average growth in the money supply has been dropping and that's what I've been concentrating on; it depends on future action starting now.

Senator PROXMIRE. There's a 2-year lag. What happened in 1982 was that you had a sharp increase in the money supply and therefore you may have a sharp increase in prices this year.

Mr. SPRINKEL. In the latter half of this year, I expect some upward movement of prices above what they were in 1983.

Senator PROXMIRE. Now do you agree with the projections that accompanied the budget document of interest rates declining and T bills declining from 9 to 5 percent, and the mortgage rate declining from 12.5 to 7 percent between now and 1989?

Mr. SPRINKEL. That's over a considerable number of years. If we conduct the kind of monetary policy that I talked about today and the kind of monetary policy the Federal Reserve is talking about, and make progress on the budget, then yes, it is possible.

Senator PROXMIRE. Doesn't that assume a tremendous improvement in the confidence of the public that inflation is under control?

Mr. SPRINKEL. Yes.

Senator PROXMIRE. You now have a difference between an inflation rate of about 4 percent and the T bill rate at around 9 percent; that's a 5 percent difference. The assumptions here say we'll have an inflation rate of 3.6 percent in 1989 and a T bill rate of 5 percent. That's only 1.4 percent. That means you've got a tremendous improvement in confidence. With the colossal deficits we're running it's hard for me to agree with it.

IMPROVEMENT IN THE INFLATION RATE

Mr. SPRINKEL. It's based on what I believe is a valid assumption: that statements by leading public officials that they're going to get inflation down mean very little, whether it is coming from the ex-

ecutive branch, or Congress, or the Federal Reserve. What does mean a lot is what actually happens. If, in fact, over a period of several years, the inflation rate continually comes down, we'll begin to believe it, and there will be some improvement—as there has been already—in inflationary expectations. If we keep inflation reasonably low over the next few years, I expect a lot more people will believe it. I might even believe it.

Senator PROXMIRE. You just conceded we'd probably have a sharp increase in inflation this year on the basis of the increase in the money supply in 1982.

Mr. SPRINKEL. I said that I expected the inflation rate to be moderately higher in 1984 than in 1983.

Senator PROXMIRE. Now on the basis of your professional experience and your experience in the Treasury, would you agree or disagree with the argument that monetary policy is responsible for most, perhaps 90 percent, of the changes in prices over the years?

Mr. SPRINKEL. Yes, sir; I do.

Senator PROXMIRE. It was a principal factor?

Mr. SPRINKEL. Yes. This is true, not only in our country. It's true in every other country I have looked at. I—and many others—I have never been able to find—and if you have the data or your staff has the data, I'd like to see it—I've never been able to find a country with high inflation and low money growth; nor have I been able to find a country with high money growth and low inflation. They go together as far back as data are available.

Senator PROXMIRE. I'm not going to argue with you. You make my point. The point is that we've had a remarkable improvement in inflation in the last couple of years?

Mr. SPRINKEL. Yes, sir.

Senator PROXMIRE. It's amazing. And the credit for that therefore should not go to the administration. It ought to go to the Federal Reserve Board. The administration has nothing to do with monetary policy.

Mr. SPRINKEL. I think they deserve a lot of credit and I have given it to them this morning and I've given it to them on other occasions as I will in the future. But we have supported that policy instead of fighting it. I think we both deserve credit.

Senator PROXMIRE. Well, you have supported the policy, but it's a policy that the Federal Reserve Board under the constitution is obligated for to the Congress, so I don't think either one of us, either the Congress or the President, can take much credit for this in view of our fiscal performance.

Do you agree with the following propositions: No. 1, the Federal Reserve monetary targets are about right for 1984?

Mr. SPRINKEL. I think they're reasonable. What I hope happens over time is a very gradual notching-down of the targets. Until eventually, gradually, we get money growth growing in line with zero inflation and 3.5 or 4 percent real GNP growth; and that is doable. We have already paid the big price for reducing inflation and it wasn't costless. We don't want to let that genie out of the bottle again.

If we can gradually pull money growth down and hit the targets—I'm not just talking about targets; I'm talking about hitting the targets. If we do that over time, I'm very confident that we can

go back to zero inflation. I can remember zero inflation. Most young people I know can't possibly imagine it.

Senator PROXMIRE. I can remember deflation, too.

Mr. SPRINKEL. I can remember that too, but it's rather p[illegible]iful.

Senator PROXMIRE. Well, let me ask you: No. 2, do you agree with the proposition that the Federal Reserve really cannot bring down interest rates from monetary policy without risking a resurgence of inflation?

Mr. SPRINKEL. They cannot bring rates down by rapid growth of money. That would have exactly the opposite effect.

Senator PROXMIRE. Therefore, the problem of high interest rates will have to be met through fiscal actions, that is closing the Federal budget deficit, given the kind of monetary policy that you already defined and that I would accept?

Mr. SPRINKEL. I expect that if we have moderately slow and stable growth in money over time with a gradual ratcheting down, then inflation and inflationary expectations will come down and so will interest rates. We have looked very hard—we've looked at the academic literature, I've had my own staff work on it—trying to find the relationship between interest rates and deficits. Intuitively, I believe it's there. Theory says it should be. I have yet to find that evidence.

There is a good relationship between inflation and inflationary expectations and interest rates. If there is a good relation on deficits and interest rates, I have not found it and I would appreciate receiving any evidence that anyone else has.

Senator PROXMIRE. Thank you. My time is up.

The CHAIRMAN. May I note for the record that I can't remember deflation. [Laughter.]

Senator Gorton.

Senator GORTON. Mr. Sprinkel, on page 7 of your written testimony you make the dramatic and I think dramatically true statement that the severity of the last recession should lead us not to the conclusion that the process of restoring price stability is too costly but that it is so costly that we cannot afford to go through it again, and am I fair in characterizing your whole message as essentially being that, that if we allow inflation to recur once again we will once again be faced with the terrible prospect of tight money controls and a recession in order to wring that inflation out of our economy?

Mr. SPRINKEL. Yes, sir; because I believe political pressures will build, as they did over the last decade, to limit inflation and that is painful. It is painful in terms of jobs and lost opportunity.

Senator GORTON. Is it fair to say that that represents a change in your point of view or the point of view of the administration between 1981 and today?

Mr. SPRINKEL. No, sir, I can remember testifying essentially to that point on earlier occasions before I came into this Government. Once there is get price stability, it is a priceless phenomenon and we should not let it get away from us. We are not there yet, but we are getting there.

Senator GORTON. Was it not the position of the administration in 1981 that we could control inflation and limit it without a recession?

Mr. SPRINKEL. We had a strategy of very gradual reduction in money which had a good shot at getting inflation down over a long period of time without causing a recession. Unfortunately, we did not get a gradual deceleration of money. We got a "cold turkey" adjustment and every economic theory I know says that if you have a quick deceleration of money growth after high money growth, the result is a recession.

Senator GORTON. So whatever the general support you expressed in answering Senator Proxmire's question about supporting the monetary policies of the Fed, it does not go far enough to include the policies of the Fed in 1981?

Mr. SPRINKEL. That's right, and we so stated at Treasury during that period.

Senator GORTON. You also stated, I believe, not only in your written statement but in answer to Senator Proxmire, that inflation will be higher in your expectation—the rate of inflation will be higher in 1984 than in 1983?

Mr. SPRINKEL. Yes, sir.

Senator GORTON. Why?

Mr. SPRINKEL. Well, partly because of the monetary expansion in 1982–83 which we have discussed. That is, the 2-year rate of money has turned up somewhat, even though it has been weak more recently. Also, if you look at the pattern of a typical economic recovery in the first year of a recovery, inflation rates frequently go down. That's what happened this last year. After that they have typically gone up.

Now I do not think it has to continue rising. It all depends on money policy. But both from the cyclical view and from the higher rate of money growth, we admit that we will have somewhat higher inflation this year. I do not expect it to be dramatically higher, but I could be wrong.

Senator GORTON. Is it possible to adopt economic policies which would prevent the rate of inflation being any higher this year than last year? If so, what would those policies be and what economic consequences would they have?

GRADUAL SLOWING OF RATE OF GROWTH

Mr. SPRINKEL. It is too late to do that. But it is not too late to prevent another repetition in 1985 and 1986. Responsible policies mean setting targets similar to the ones set by the Federal Reserve this week and attaining those targets; that means over time a very gradual slowing of the rate of money growth.

Senator GORTON. Would the adoption by the Congress of fiscal policies which sharply reduced the deficit from what it will be under our current services budget or even under the President's proposed budget have any impact on the rate of inflation or on interest rates?

Mr. SPRINKEL. I would not expect it to have a dramatic effect on the rate of inflation, but it would have many other highly desirable effects.

Senator GORTON. What would those other effects be?

Mr. SPRINKEL. Well, primarily, that we release savings that I absorb in my role of financing the deficit and permit those savings

to be utilized in the private sector of the economy, which is much more efficient. Then we can get real growth of greater magnitude, more jobs, higher real income—that is my concern about a perpetually large deficit. So it is critically important that we reduce the deficit and I think that is generally agreed upon by most of the Congress and certainly by this administration. There is some debate about how we do it. There is quite a debate about how we do it, and that entails some difficult choices.

Senator GORTON. Let's ask the reverse of that question. Yesterday before the Senate Budget Committee, Mr. Penner testified that in fiscal 1983 the Federal deficit amounted to 107 percent of domestic net savings and will still be at 80 percent of domestic net savings in 1984.

If we don't do anything about budget deficits, if the country continues to use such a large share of its savings to finance that deficit, must not a real economic growth inevitably fall nearly to zero or at least be sustained only by foreign capital inflows?

Mr. SPRINKEL. It will certainly put a damper on real economic growth. It is hard to measure how much. I think it is important to recognize that the real problem is that Government spending as a percent of GNP has gone up very substantially, while taxes as a percent of GNP have been quite flat. We are already allocating those resources to Government. And from my point of view, the important thing is to get better control over spending over time so that we can close the gap that the deficit clearly represents.

Senator GORTON. Did the tax cuts of 1981 increase the rate of savings in the United States?

Mr. SPRINKEL. It's a little difficult to answer because I am a little suspicious of the data. If you look at the national income data, there is no evidence. If you look at some indirect data such as the Federal Reserve flow of funds—and you cannot reconcile the two, unfortunately—there is rather clear evidence that holdings, liquid assets have gone up very substantially.

Now I believe that when you cut marginal tax rates and deregulate the financial system, giving savers more options and higher rates of return, I would expect that to have an effect on savings in a positive way; and I believe it did, but I certainly cannot prove it because of the data problems.

Senator GORTON. But in spite of the uncertainty of the answer to that question, are you convinced that a tax increase this year would reduce the rate of savings?

Mr. SPRINKEL. Yes. I think all tax increases have an adverse effect on incentives, but some kinds of tax increases have more adverse effects than others.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Humphrey.

Senator HUMPHREY. Mr. Secretary, I'm new to this committee and I think I agree with what I've heard you say here today in large measure and likewise with what Mr. Volcker had to say yesterday, and you seem to agree on one important point—the two of you—that the monetary policy should be to provide a stable and moderate monetary growth at a rate consistent both with price stability and sustainable real economic growth, and the implication is that if the rate of monetary growth is too high, then we would reap

inflation; and if it were too low, then we would reap high interest rates and economic slowdown.

The question is how do you or we decide what is the proper monetary policy at any given time? How do we know, for instance, right now at this critical juncture, with lots of worrisome things happening in the financial marketplace at the moment—how do we know that monetary policy isn't too restrictive for these particular circumstances pertaining today and for the next couple weeks?

You noted in your testimony that departures from goals can be justified under certain circumstances. Are we at one of those junctures where we can justifiably depart?

Mr. SPRINKEL. The real reason that I recommended moderate, stable, predictable money growth is because of my ignorance and other people's ignorance. No one can know with certainty what the future will bring. There is no way to know with certainty. We know something about the past, but we don't even know what is happening to the economy today. Economic data is available with a lag of a month or two; but then the preliminary data is often revised. So there's a great lack of timely knowledge.

Senator HUMPHREY. Yes.

Mr. SPRINKEL. Therefore, massive changes in money lead to even greater uncertainty and what I'm recommending—and I believe the Federal Reserve agrees with this—is that we shouldn't try to fine-tune because we are not that smart; the prudent cause is moderate growth in money. Over time, you gradually, very slowly, reduce the rate of money growth until it is consistent with our long-term real economic growth potential, which might be 3.5 or 4 percent, depending on what we do about savings and investment incentives in the months and years ahead.

Senator HUMPHREY. Yes, but if that stable growth is too low under the circumstances, then it isn't so virtuous after all, is it?

Mr. SPRINKEL. Well, as I indicated in my testimony, I am concerned about the sharp deceleration in money growth that has occurred over the last 6 months or so. The reason for that concern is that if you go back and look at history—I come from Missouri and we have a motto around there that says "show me," so I don't believe things that I can't find some evidence for—if you go back and look at that evidence, you find changes in real economic growth—that is, things you and I are interested in—employment, jobs, profits, production—are related to sharp changes in money growth, not levels, changes in growth rates. Even after the revised numbers that were issued recently, there has been a very substantial deceleration in money growth from the first half of last year.

Historically, that has inevitably led to a slowdown, sometimes a recession. In 1966 it led to a slowdown, but not a recession. We had two quarters of essentially no change in real GNP. On other occasions it's led to a grinding downturn; I am not smart enough to know what is going to happen this time, but I am quite confident that we're in the process of slowing down. Certainly the equity markets suggest that as well.

SLOW GROWTH COULD LEAD TO ANOTHER RECESSION

Senator HUMPHREY. Now you said earlier—I was only half listening when I was reading some of your testimony— you said earlier, if I heard you correctly, that the only question about the future is how severe the recession will be that is coming; is that correct?

Mr. SPRINKEL. No. I said there will be a slowdown, even a significant slowdown in the rate of growth is a possibility, but I wouldn't call it a recession. But if we continued to get very slow money growth for another 6 months, I certainly would expect a recession. I am not predicting that we will—the last 2 months, December and January, witnessed pretty good growth in money and I hope it continues.

Senator HUMPHREY. Getting back to this option of flexibility, on page 10 of your testimony, you say, "There is no inconsistency between setting and following monetary targets and maintaining basic flexibility to respond to changing institutions or developments."

Do you not see the action of the stock market over the last couple of weeks—in fact, of the broad market over the last 4 or 5 months as a sign there's a changing development that ought to be paid attention to and should be the cause of our changing course somewhat in monetary policy?

Mr. SPRINKEL. I follow the markets very carefully and I wrote three books on the relationship between money and equity prices, so it's not a new idea to me. Inevitably when you get a severe squeeze--a sharp slowdown in the rate of growth in money—you typically get a weak stock market, and that weak market inevitably precedes a slowdown in economic activity.

Senator HUMPHREY. Well, the market is weak because people are worried about decreased profitability and a slowdown in the economy. Isn't this reduction in growth of supply of money causing lower stock prices? People worry about the economy, and profitability, and so on?

Mr. SPRINKEL. Yes, I agree with that.

Senator HUMPHREY. Well, then are you supporting the present growth targets by the Federal Reserve?

Mr. SPRINKEL. Yes, sir; I am.

Senator HUMPHREY. You don't think they're too restrictive? Apart from the stability, you don't think they're too restrictive?

Mr. SPRINKEL. No, sir; I do not. There was a very modest downward notching of targets. We have been fully supportive of all of their targets since we have been in office, and I hope to remain in that position. We urge that they attain those targets.

Senator HUMPHREY. I'm certainly not making excuses for sloppy fiscal and irresponsible fiscal policy which this Congress is pursuing, but I hope that the Federal Reserve will not operate in an ivory tower just to show how virtuous it thinks itself is. It's my opinion that monetary policy is too tight. It's going to send us into a situation of recession with Federal revenues falling, demand for Federal expenditures rising, and that situation will just get very much worse if we don't have easier monetary policy.

I'm not calling for monetization of the deficit, but I do think we're erring on the side of being too low, too tight in our monetary policy.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Beryl, thank you for your testimony. You're here presenting the administration point of view. Part of what you've said is that to the extent there are problems, much more have to do with the way the Federal Reserve handles monetary policy than the way Congress and the administration has handled fiscal policy. Is that correct?

Mr. SPRINKEL. I didn't mean to say that, Senator Heinz. I was asked to talk on monetary policy. I could have given different testimony on fiscal policy. I have great concerns about how we are handling fiscal discipline in this country.

All I said was that since we have not exerted discipline on fiscal policy, it's even more important that we have a moderate, steady, predictable monetary policy. They are equally important, but for somewhat different reasons.

Senator HEINZ. I think that's a helpful clarification. So that I understand you, you are saying that the Federal Reserve has just been too unpredictable?

Mr. SPRINKEL. Yes, sir.

Senator HEINZ. Is the problem their inability to control from week to week and month to month the aggregates and the other outcomes of their methods, or is it that you think they should pursue either higher or lower growth rate?

Mr. SPRINKEL. I do not believe that they are unable to achieve targets. The Federal Reserve staff—and they are the experts—have said that if they chose to do it, they could hit a monetary target within plus or minus 1 percent on average each quarter. I believe it is improbable that such a good result would occur, however, given the Fed's present operating technique. We have suggested some important changes, one of which has already been implemented and we applaud that.

Senator HEINZ. Contemporaneous reserve accounting?

Mr. SPRINKEL. Yes, sir. But in addition to that, instead of focusing on the Federal funds rate, I would urge that they focus either on bank reserve growth or on the monetary base—I don't much care—and that we have a flexible discount rate.

Senator HEINZ. My question was not so much what you suggested. I asked you whether the problem with the Fed policy was its periodic variability in hitting the center of its target range or whether you thought the targets were, per se wrong?

Mr. SPRINKEL. No, it's the variability.

Senator HEINZ. And if you thought the targets were wrong, whether they should be higher or lower.

Mr. SPRINKEL. It's the variability, not the targets.

Senator HEINZ. And therefore, if the Fed got pretty much the same result that they got last year, which is in aggregate as I recollect Mr. Volcker's testimony, on a corrected basis, they hit pretty much the middle of their target range for M_1, M_2, and M_3, you're saying that if on a week-to-week and month-to-month basis, if they

had been more consistent, real interest rates would be lower. Is that right?

Mr. SPRINKEL. Not on a week-to-week or month-to-month basis, because I don't think it is technically possible. I do believe it's possible on a quarter-by-quarter basis and I would expect that if we get more stable money growth, that would reduce interest rates as well as contribute to decreased inflationary expectations.

Senator HEINZ. So if they had done better on a month-to-month basis, we would have lower real interest rates?

Mr. SPRINKEL. Quarter-to-quarter.

Senator HEINZ. Quarter-to-quarter, I apologize. If there had been less variability in their performance we would have had lower real interest rates?

Mr. SPRINKEL. That is my judgment. It is not a hip pocket estimate. We have done a lot of technical work on it, so we believe we have good evidence supporting that statement.

Senator HEINZ. I understand. Now they did come in over the last 12 months aggregated about where I think you would want them to come in; is that right?

Mr. SPRINKEL. Yes.

Senator HEINZ. If they had done it your way or as you have suggested within the technical limits of plus or minus 1 percent on average quarter-to-quarter, how much lower might—I'm not expecting to get a precise forecast, but how much of a drop in real interest rates might we have seen? Are we talking in the neighborhood of one-eighth of 1 point or 2 points or what are we talking about here?

Mr. SPRINKEL. When we did the paper sometime asking the question—how much has monetary variability added to nominal interest rates—the numbers that came out in the range of 200 to 300 basis points. So it is not insignificant. There are some people that think that's somewhat of an overestimate. Some people believe the estimate is 100 to 200 basis points.

Senator HEINZ. Which is the same as 2 to 3 interest points, is it not?

Mr. SPRINKEL. Yes, sir.

Senator HEINZ. That's a very large amount.

Mr. SPRINKEL. I think it's worth trying to capture a portion of it.

Senator HEINZ. If it's true, it certainly is. You may be right, Beryl. I find it difficult to believe that the amount of variability you're talking about—and I, like you would like to see less variability—but I find it difficult to believe that straightening the line out on Fed quarterly performance would bring interest rates down even 2 points. If it were true and you could do it, you'd be a genius. It's not that I don't think you're a genius, it's just that I don't think it's true.

Mr. SPRINKEL. Well, Senator Heinz, I will be very pleased to share with you the evidence that we have. That's all I can say.

Senator HEINZ. I hope that's not the same evidence that Don Regan told us about in which all of the tax cut would go into savings.

Mr. SPRINKEL. I don't remember that statement.

Senator HEINZ. Unfortunately, the Finance Committee has a transcript of the hearing.

OVERVALUATION OF THE DOLLAR

Let me turn, if I may, to the question of the trade deficit which is $70 billion this year. You mentioned in your remarks earlier that you're very concerned about what's happening. As I recollect, you indicated the problems with capital formation, productivity, job creation; and yesterday Mr. Volcker said that if the dollar remains overvalued for much longer we're likely to see real long-term structural damage to our most competitive U.S. industries. I gather you would agree with that?

Mr. SPRINKEL. I did not read the total statement. I don't know what it means to say the dollar is overvalued. We have a very large free market where buyers and sellers in a highly competitive situation representing $30 or $40 billion in New York City alone—estimated over $100 billion a day worldwide—get together and bid against each other and the rates fall out. The usual computations concerning whether it's overvalued or undervalued are based on very slippery evidence from my point of view; that is, they use typically purchasing power estimates and they find some period in the past where it was magically correct—I don't know how they identify that period—and then they observe price changes since then and they say today it is obviously x percent overvalued. But that leaves out many other considerations—capital flows and other adjustments. Consequently, I just cannot buy the statement. I can certainly agree that the dollar is a lot higher vis-a-vis most other currencies, except the yen, over the last 2 or 3 years; but to say it is overvalued, I cannot.

Senator HEINZ. One way of judging the overvaluation of the dollar, I would suggest, is the trade deficit. If we had been running a trade deficit somewhere in the range of zero to $30 billion and suddenly it goes to $70 billion and it's projected to go to $130 billion, all during the 3 years that the administration has been on block, there are two possible analyses.

Either, one, that in the last 3 years the country under Republican stewardship has lost its competitive ability inherently, or the dollar is making a mess of our international competitiveness. It's either happening overseas or it's happening at home. Now which is it?

Mr. SPRINKEL. I have views as to why the dollar rose and that's essentially what you're asking.

Senator HEINZ. No. What I'm asking is, we've got a big trade problem.

Mr. SPRINKEL. Yes.

Senator HEINZ. And it's $70 billion and it's going to be nearly twice as much next year, this year is twice as much as last year, and it means one of two things is wrong. Either in the last 3 years things have gone to hell in the United States and we're getting less competitive and we're going backwards in terms of our industries, or for other reasons having to do with the interplay of fiscal and monetary and market forces around the world the dollar is overvalued. Those are the only two reasons that it could be this way. There's no third alternative.

Mr. SPRINKEL. I find it——

Senator HEINZ. Other than taking the fifth amendment.

Mr. SPRINKEL. I find it very difficult to believe that the situation in the United States is so dire when I recognize from all over the world people are bringing money here because of high rates of return, because of confidence that we are getting inflation under control. This is what, in essence, is driving up the dollar. This, in turn, has created a trade deficit and that is, of course, working against a further appreciation of the dollar.

So it is good developments in the United States—respect for the dollar, belief that a dollar will be a dollar—that causes most people to value the dollar. That includes both profitable rates of return here and it also includes political instability abroad.

Senator HEINZ. I would agree with much of what you just said. I would perhaps be tempted to say that it's not so much a question that the dollar is outstanding. After all, I think you and I both learned as well as we're taught that when trade deficits get larger and larger there is a day of reckoning at which point people who are putting the money into your country with the trade deficit says, "Say, I wonder how we're ever going to get paid back," and I suspect, therefore, it's not so much that we're doing a terrific job over here; it is, who wants to hold francs; who wants to hold crusaros; who wants to hold deutsche marks, especially with all the people running around near the military bases?

Just because we are the best of the lot doesn't mean that we are performing the way you or I would want to perform.

Mr. Chairman, I know my time has expired. I will just make this one comment. I thank Beryl Sprinkel for his answers. I really worry, Beryl, that the dollar in fact is overvalued and I think we've discussed pretty much the dynamics. I think we can both be right in the context of the discussion as to why it is overvalued. In a sense, thank God it is overvalued because if it wasn't interest rates, instead of being 10, 11 or 12 percent, would be 15, 16, and 17 percent, and we wouldn't have the liquidity to finance what we've got without the capital flowing in, but I worry that what we've got is going to bring about the deindustrialization across the board in all our capital intensive, high tech, and competitive industries. I worry that we're going to experience a deindustrialization of the United States. That is quite the contrary to what the administration and all of us want. Indeed, the whole idea behind having tax incentives for investment was to reindustrialize the United States. I believe that the deindustrialization follows from a budget deficit that is out of control, when the market reacts as it does, down 24 points after yesterday's advance, Don Regan being a part of it, his statement being a part of it, but probably the reality of the President's downpayment apparently isn't a downpayment; the $180 billion deficit includes the downpayment, at least based on the events of yesterday in the 14 measures submitted to the "Gang of"—however many they are. I think we have something very serious to worry about and I know you worry about it, the question is I wonder if we're doing enough about it.

I appreciate your testimony on the monetary policy side. I think you have made some good suggestions, irrespective of whether it's 200 or 300 basis points or not, they probably should be pursued. Thank you.

The CHAIRMAN. Thank you, Senator Heinz.

Mr. Secretary, we appreciate your willingness to testify before the committee and, as always, you're very articulate and very direct. The committee appreciates the fact that you do answer questions in a manner that is not evasive and we're able to understand you. We appreciate that very much. Unfortunately, all witnesses that we have before this committee over a period of time do not do that. So we especially appreciate your candor. Thank you very much.

Mr. SPRINKEL. Thank you, sir; my pleasure.

The CHAIRMAN. Our next witness is the Honorable Martin Feldstein, Chairman of the Council of Economic Advisers.

May I say while we're changing that Senator Proxmire has a question that we'll submit to you, Beryl, for a response from you in writing.

QUESTION SUBMITTED BY SENATOR PROXMIRE FOR THE RECORD

Whether you believe budget deficits and high interest rates are the cause of misaligned currencies, I was delighted with the Agreement made in November during President Reagan's visit to Japan that was aimed at strengthening the value of the yen relative to the U.S. dollar by increasing international demand for the Japanese currency.

I understand the Japanese made commitments to (1) eliminate the real demand rule in forward exchange transactions; (2) reform their designated company system; and (3) issue foreign currency denominated national bonds. Recently we have read that the Japanese are reneging on some of those promises.

Can you give us a status report on where things stand? Do you expect that the misaligned yen/dollar rate can be cured and if so when?

Answer. The Japanese have followed up on a number of the specific steps announced during President Reagan's trip to Japan last November.

The Ministry of Finance [MOF] has confirmed that measures to eliminate the real demand rule will be published in the official gazette prior to April 1, 1984.

MOF has also confirmed that the inter-ministerial consensus has been reached to eliminate the designated company system. Necessary legislative measures have been incorporated in an omnibus bill which was approved by the Japanese cabinet on February 28 and will be presented to the Diet in March.

The omnibus bill also contains measures to allow MOF to issue foreign currency denominated national bonds abroad in conformity with foreign practices.

The minimum denomination of CD's was lowered from ¥500 million to ¥300 effective January 1, 1984. It has also been announced that the ceiling on issues of CDs for Japanese banks will be expanded beginning in the April-June quarter of 1984 until the ceilings reach 100 percent of a bank's net worth in April 1985.

Foreign bank CD ceilings are to be raised to 50 percent of total yen assets from 30 percent, with the minimum ceiling allowed raised from ¥5 billion to ¥8 billion, both effective April 1, 1984.

MOF has also confirmed to us its intention to ease the guidelines on issues of Euro-yen bonds by residents, effective April 1, 1984.

We are hopeful for progress in the establishment of a banker's acceptance market and revisions in the withdrawing tax on interest earnings on Euro-yen bonds held by foreigners, although the November 10 announcement commits the Japanese to neither.

As you know, we are continuing to hold discussions with the Japanese through an Ad Hoc Working Group on yen/dollar issues which I jointly chair with Vice Finance Minister Oba. I have just returned from the first such Working Group meeting, which was held in Tokyo on February 23-24. We had extensive, frank discussions in which I emphasized the need for a fundamentally new approach to internationalizing the yen and liberalizing Japan's capital markets, not just marginal changes in one financial instrument or another. I believe our meeting was successful in conveying to the Japanese the importance we attach to significant change on their part, as well as some concrete suggestions for going about it. Although no new steps were announced at the first meeting, we have agreed to resume our discussions in Tokyo on March 23-24.

Mr. SPRINKEL. Thank you.

Mr. Chairman, we are happy to have you before the committee again and if you would like to proceed we are ready to hear what you have to say.

STATEMENT OF MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. FELDSTEIN. Thank you very much.
[Complete statement follows:]

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MONETARY POLICY, BUDGET DEFICITS AND THE ECONOMIC OUTLOOK

Testimony

by

Martin Feldstein, Chairman

Council of Economic Advisers

before the

Senate Committee on Banking, Housing, and Urban Affairs

Washington, D.C.
February 9, 1984

Monetary Policy, Budget Deficits and the Economic Outlook

Martin Feldstein*

Thank you Mr. Chairman. I am pleased to appear again before this distinguished Committee. I will begin my remarks by discussing monetary policy. I will then turn to the budget deficits and the economic outlook.

Monetary Policy

The fundamental guiding principle of the Administration's approach to monetary policy is that the rate of growth of the money stock should be reduced gradually over the years until the rate is consistent with price stability. This principle is consistent with the general approach enunciated in recent years by the independent Federal Reserve.

Controlling the growth of the money stock should not be viewed as an end in itself but rather as a means of achieving a desirable path of nominal GNP. Because the growth of nominal GNP tends to follow the growth of the money stock, this strategy of monetary policy can be expected to be consistent with a gradual decline in the growth of nominal GNP and in the rate of inflation, although the mix of real growth and inflation is subject to other influences as well. In the

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* Chairman, Council of Economic Advisers. Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, February 9, 1984.

remaining years of this decade, this decline in the rate of growth of nominal GNP should be compatible with continuing growth of real GNP and with a continuing decline in the rate of inflation.

In previous testimony, I have discussed the difficulty of applying the principle of steady monetary deceleration in a time of rapid institutional change. An appropriate monetary policy must balance the principle of steady monetary deceleration with the need to take account of changes in asset preferences or institutional arrangements that cause sustained shifts in the velocity of money, i.e., sustained shifts in the ratio of nominal GNP to the money stock.

The year 1983 was a time of significant change in financial regulations that substantially altered the nature of the monetary aggregates (M1, M2, and M3) and the pattern of portfolio demand for monetary assets. In December 1982 banks were permitted to offer money market deposit accounts, a form of small-denomination time deposit with no limit on the permitted interest rate. These deposits were classified as a part of M2. Within 4 months, these deposits grew to $321 billion, or more than 15 percent of M2. The funds that were deposited in money market deposit accounts came from M1 balances, from other components of M2, and from sources that are not part of M2 but of either M3 or the broader liquidity aggregate.

Between December 1982 and March 1983, savings deposits declined $40 billion and small-denomination time deposits other than money market deposit accounts declined $116 billion; both of these are components of M2. Money market mutual fund balances declined $35 billion and large-denomination time deposits declined $37 billion. In addition, the introduction of money market deposit accounts encouraged some intermediation of borrowing that might otherwise have occurred through direct corporate borrowing and the direct public purchase of Treasury securities. The net effect of all of this on M1 and M2 could not be evaluated with any reasonable degree of reliability.

A second regulatory change added to the fundamental realignment of the monetary aggregates. Beginning in January 1983, financial institutions were permitted to offer Super-NOW accounts, a checkable deposit with no ceiling on the interest rate. These accounts, classified as part of M1, have grown to nearly $40 billion. They presumably attracted funds from other types of M1 deposits as well as from M2 and M3. This added to the difficulty of interpreting changes in the monetary aggregates during the early months of 1983.

Between December 1982 and March 1983, M1 rose 3.3 percent and M2 rose 5.2 percent. Although these are equivalent to annual rates of increase of 13.9 percent for M1 and 22.5 percent for M2, it would be inappropriate to interpret these one-time portfolio shifts as part of the annual growth of the monetary aggregates. The rise in money market deposit accounts and in Super-NOW accounts slowed considerably in the second

quarter. Between March and September, M1 rose at an annual rate of 9.3 percent and M2 rose at an annual rate of 8.0 percent.

The desirability of stable money growth rests primarily on the stability of the demand for money relative to nominal GNP. A change in the available mix of financial assets or in the characteristics of the monetary aggregates is likely to change the equilibrium ratios of nominal GNP to the monetary aggregates. The Federal Reserve can in principle adjust the supply of money to compensate for the shift in demand without altering the degree of liquidity in the economy or, equivalently, the likely growth of nominal GNP. The rapid increases in the monetary aggregates in the early part of 1983 were consistent with an unchanged path of decelerating nominal GNP to the extent that they only compensated for the changes in money demand that resulted from the change in available financial deposits.

Unfortunately, however, there is no way to know by exactly how much the financial deregulation changed the demand for each of the monetary aggregates. The Federal Reserve appears to have followed a relatively passive strategy during the early months of the year, not putting pressure on bank reserves but rather focusing primarily on those broad measures of money and credit -- M3 and L -- that were little affected by regulatory change. The narrower monetary aggregates -- M1 and M2 -- were allowed to grow at whatever rate was consistent with this policy.

With the banking system's reserve position relatively unchanged, short-term nominal interest rates also varied little. Between December 1982 and May 1983, the monthly average of the 91-day Treasury bill rate varied between 7.9 percent and 8.4 percent. After May, however, the Federal Reserve became concerned that the narrow aggregate not rise too quickly. It permitted the short-term interest rate to increase. More specifically, in July the Federal Reserve indicated that the unusual expansion of M1 in the period of transition seemed to be abating and that it would seek to maintain M1 in a monitoring range based on the average level of that aggregate in the second quarter of the year. The Federal Reserve also indicated that it would give primary attention to M2 and M3.

The Federal Reserve approach to the very difficult task of adjusting the money growth targets to the new regulatory environment thus far appears to have succeeded. There are some observers, however, who are less sanguine about the possible delayed effects of recent monetary policy. They worry that the rapid expansion of the monetary aggregates in early 1983 may lead to near double-digit inflation by the end of 1984. They fear also that the slow growth of M1 in the second half of 1983 may cause output to decline by the middle of 1984. Of course, neither possibility can be ruled out completely. All that can be said with certainty at this time is that monetary policy has come through a very difficult year of substantial deregulation without any apparent problem yet in either real growth or

inflation. Moreover, the currently available statistics indicate that all three monetary aggregates ended the year 1983 inside the ranges that the Federal Reserve had established earlier in the year.

All too often at this stage of an economic recovery, as growth slows from the unsustainable pace of the recovery's first year, political pressures have built to try to reduce interest rates through an expansionary monetary policy. The present high level of real interest rates and the rise in interest rates since the beginning of the year have brought forth calls from many quarters for easier money. There are some who want to hide the adverse effects of the budget deficits on the interest-sensitive sectors of the economy by an excessively expansionary monetary policy. They are joined by others who simply want to see faster economic expansion this year regardless of the inflationary consequences.

The Administration rejects these calls to abandon a sound monetary policy. The projected series of large budget deficits has raised real long-term interest rates to high levels that cannot prudently be lowered by an easier monetary policy. The Administration recognizes that if the Federal Reserve were to try to maintain a strong recovery regardless of the other economic consequences, the expansion of money and credit might be so rapid that the rate of inflation would rise and undercut the prospect for a sustained expansion.

The Administration desires a steady growth of real GNP and a gradually declining inflation rate. If there are no

unexpected shifts in velocity, the monetary policy consistent with this outcome would be gradually declining rates of growth of the monetary aggregates. Although no regulatory changes comparable to those of 1982 and 1983 are expected, future shifts in asset preferences or institutional arrangements (such as permitting interest on demand deposits) could cause changes in velocity that would require a recalibration of the money growth targets. It is important that any such recalibration be made only in response to a significant and persistent shift in velocity. The willingness to recalibrate money growth targets in response to sustained shifts of velocity must not degenerate into either economic fine tuning or a misguided pursuit of interest rate targets.

Budget Deficits

The most significant economic problem now facing the Congress is the very large budget deficits that are projected for the years ahead if no legislative action is taken. These budget deficits would have serious adverse consequences in both the near term and the more distant future. In the near term, budget deficits create a lopsided recovery that is inherently slower, more fragile, and more prone to inflationary pressures. In the longer term, such large budget deficits would raise the cost of servicing our national debt and would crowd out investment in plant and equipment and in housing. The result would be a greater tax burden and a lower level of real income.

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The bipartisan negotiations on the budget deficit provide the best opportunity for making timely progress in bringing the deficits under control. A combination of spending cuts and additional tax revenue that reduced the deficits of the next three years by $100 billion or more would be a very helpful downpayment. It would, of course, be only a first step. In 1985, Congress must enact further measures to put the deficit on a sharply declining path.

If the current negotiations are successful and if they are followed by larger steps in 1985, the major impediment to a healthy economic expansion will have been eliminated. I believe that if deficits are shrinking appropriately and monetary policy follows a sound course, the American economy can experience years of solid growth with declining rates of inflation.

The opportunity to negotiate and enact a downpayment on the budget deficit is also the opportunity to enact a downpayment on a healthy expansion in the years ahead. I fervently hope this opportunity will not be wasted.

The CHAIRMAN. Thank you very much.

Let me say, for one, I appreciate your courage in speaking out on the deficits. Some may not, but this Senator does, and I think you know that. We have had many conversations about it over the last couple of years.

Mr. FELDSTEIN. Thank you very much.

SPENDING CUTS MUST ACCOMPANY TAX INCREASE

The CHAIRMAN. I discussed yesterday with the Chairman of the Fed the economic and political problems with achieving reduced deficits. I want to pursue the same line of questioning with you. Obviously, there are those who, for whatever reasons, political or otherwise, want to harp about solving the problem with only tax increases. Then there are those who would only do it with spending cuts, of which I am one. And then the political side of it is recognizing that neither is possible, I'm one who would be willing to vote for a combination if it could be put into a package where the spending cuts were guaranteed.

Over the 9 years that I have been in the Senate I have often heard that tax increases are the way to reduce deficits; what we need is more revenue. That has never turned out to be the case and we have had many tax increases over those 9 years and I used the example yesterday of a fellow—and this is a specific example—of one who I know who is greatly in debt and had some very serious financial problems, was fortunate enough to get a job that increased his pay dramatically. It did not solve his problem because he spent more and he's continued in that cycle. There are a lot of people like that. It doesn't matter how much income they have, they will spend more.

That has been true of the Congress and the Federal Government. It has not made any difference how much revenue we could raise, we have spent more. That was true of TEFRA in 1982. It's the only tax increase that I've voted for since I've been in the Senate and I regret it. If it had gone the way that we were promised, we would have received expenditure reductions of at least $98 billion, hopefully more, to match the $98 billion of tax increases, that's a much larger amount and we're talking about the downpayment now. That's $196 billion over 3 years. To get the tax increases we got more than a dollar's worth of spending increases for each dollar of tax revenue.

So that's why I totally discount, at least politically, the prospect of having any meaningful reduction in deficits if we have a tax increase. It hasn't happened before. I don't know what would change the performance of Congress suddenly now.

Would you agree, in your experience of watching Federal budgets? Can you tell me of a single time in the last decade where an increase of revenues from the backs and the pocketbooks of the American people has reduced deficits, or has it just been spent with a little added spending to go with it?

Mr. FELDSTEIN. Of course, Senator, it is very hard to know what would have happened to spending in the absence of that tax increase.

The CHAIRMAN. As a member of the Appropriations Committee, I can tell you what would have happened. Spending levels have not been restricted. We simply sit in the Appropriations Committee, even with all the rhetoric this year from every side, liberals, conservatives, Democrats, Republicans, and say we've got to do something about the deficits, and I have seen nothing but amendments for add-ons over and over and over again and markups in the subcommittees and the subcommittee chairman the day that one of my colleagues on that subcommittee walks in and says, "Senator, I've got an amendment to reduce the HUD independent agencies' budget," I will undoubtedly drop dead from shock. It simply has not happened. So I don't think the expenditure levels are driven by the amount of revenue. I doubt very much if they have any idea what the revenue levels are. It's simply a need that they think needs to be filled.

Mr. FELDSTEIN. If it is true that the spending goes on independent of the revenue, then TEFRA reduced the $98 billion accumulative deficit over those years by $98 billion because the spending was going along on its own track.

The CHAIRMAN. I agreed with the Chairman yesterday that the deficits could have been larger, but the intent was to reduce them, not to reduce the rate of growth, but to reduce them.

Let's move on then to the second part of my concern with doing it with tax increases, even though politically I'm willing to—because I'm so concerned about the deficits—to go with a mix if we can get that. Maybe we ought to do it the other way. Maybe we ought to cut spending and promise the taxers that next year we will give the tax increases to go with it and see if they trust us because I don't trust them any more.

What about the situation of the impact on the economy?

Let's use the same hypothetical I did yesterday. Let's go to $200 billion deficit and say that we have a $30 billion tax increase, $170 billion deficit. Everybody says that's wonderful, we're glad that we got that kind of reduction. But with the exception of the interest saved, say if you're looking at 10 percent, $3 billion of interest on that $30 billion, aren't we still taking $200 billion out of the private sector? Aren't we still crowding out money for the mortgage loans, automobile loans, venture capital, and modernization of plant and equipment? Isn't the impact on the economy of removing that $200 billion——

Mr. FELDSTEIN. If you take that hypothetical, it depends on how the $30 billion in tax revenue is raised. There are obviously ways that you can raise it that would make almost all of it come out of savings, but the most likely thing is that a large portion of it would come out of what otherwise would have been consumed.

Of the $30 billion that individuals would pay in extra taxes in that example, perhaps $20 billion would otherwise have been consumed and $10 billion might have been saved. To that extent, the extra taxes would yield a net increase of $20 billion for investment, mortgages, and lending. Unless all the tax revenue comes out of savings, there is some net increase out of that tax increase.

The CHAIRMAN. I understand there are different ways to raise the tax money and different places that it comes from, but whether you spend it—if you spend it and get that net reduction you're

talking about, somebody profits from that spending, somebody builds a washing machine that's sold and there's revenues generated from consumption as well.

TAX REVENUE SHOULD BE PROPORTIONAL WITH GNP

Mr. FELDSTEIN. The easiest way to think about it is that the amount of revenue that the Government collects for a given tax structure does not depend on how our GNP is spent. Whether it is spent on one kind of goods or another, it will create profits and there will be tax revenues out of that, and it will create wages and there will be tax revenues out of that.

I think about the tax revenue being proportional to our GNP, and if we have more investment and less consumer spending, that will not change the total amount of tax revenue.

The CHAIRMAN. Let's get to the overall general point I'm driving at. You have been an advocate of increased revenues as well as decreased expenditures in order to get a reduced deficit and have a positive impact on the economy, the financial markets, and the interest rates that we would like.

Is it correct that from strictly an economic standpoint that if you had your choice you would much, much prefer to reduce those deficits with expenditure cuts rather than tax increases?

Mr. FELDSTEIN. In general that is true. Again, it depends on exactly what expenditure cuts we are talking about. But in general, increasing taxes would add more adverse effects on the economy, while reducing spending would not have that distorting effect on savings incentives and work incentives. Therefore, I would prefer, all other things being equal, to do it by reducing spending rather than by increasing taxes.

The CHAIRMAN. Again, my point is, however you tax it, in my opinion, it is better to have it go into saving, have it go into spending, whatever use the private sector wants to put it to is better than having Government make those choices. So I assume that your recommendation of tax increases, then, with expenditure cuts has to be a political decision like mine, that that is the only realistic way, rather than a belief, as mine is, that it would be much, much better to cut down spending rather than increase the tax burden. So both of us are facing the political realities of trying to achieve a compromise; is that correct?

Mr. FELDSTEIN. That is correct. Certainly if I were given the freedom to pick and choose the $30 billion of deficit reduction, I would rather have the spending reduction than the tax increase. But I do not have that choice and, as you said, the political process tells us that we are not going to be able to do it just on the spending side.

The CHAIRMAN. Well, I agree with your political assessment. Unfortunately, it's probably worse than either one of us, even trying to get that kind of a mix as we found in 1982 is difficult. I wish I could also understand the philosophy that somehow it's politically popular to advocate tax increases and that it is correct economic theory as we come out of a recession to remove more money from the economy for governmental purposes. I have not found too many economists that normally advocate that that is a good thing to do.

It used to be the old pump-priming, that we need more money out there, rather than less.

Mr. FELDSTEIN. What we do not need are not growing Government deficits as we come out of the recession. The cyclical deficit is shrinking in the normal way, but we now have a growing structural deficit, and that is why people are concerned.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Dr. Feldstein, do you agree or disagree with Secretary Sprinkel?

Mr. FELDSTEIN. In general or in some specific area?

Senator PROXMIRE. Well, I'm sure there are many areas where you agree with Secretary Sprinkel, as I do, but do you agree with his observation that monetary policy alone determines the inflation rate and that fiscal policy has no effect on inflation; or do you think they both have some effect?

Mr. FELDSTEIN. Over a sustained period of time, rather than what happens to the inflation rate in 1985 or what happen to the inflation rate over the next decade, monetary policy is the overwhelming influence on it.

Senator PROXMIRE. But you would give some limited influence to fiscal policy in the short run?

Mr. FELDSTEIN. I would give some limited influence to fiscal policy in the short run. More generally, it is sometimes hard to think about monetary policy as being completely separate from fiscal policy and able to operate independently. But insofar as you can think of it as being able to operate completely independently—that is, not independent politically, but I rather mean independent of fiscal stimulus and independent of what happens in the marketplace, such as what happens to oil prices and so on—then I would say that except in the short term, monetary policy is the overwhelming determinant of price levels and inflation.

Senator PROXMIRE. Now you say in the next to the last paragraph, "If the current negotiations are successful and if they are followed by larger steps in 1985, the major impediment to a healthy economic expansion will have been eliminated. I believe that if deficits are shrinking appropriately and monetary policy follows a sound course, the American economy can experience years of solid growth with declining rates of inflation."

GROWTH RATE OF 4 PERCENT IS PROJECTED

Now the growth that is projected is about 4 percent for the 1980's in each year except 1989 where it's near 4 percent. In the 1970's it was roughly 3 percent; and in the 1970's, we did not have deficits nearly as high as we have now. And it seems to me that coming down off a very high level of the deficit would tend, at least temporarily, to slow economic growth inasmuch as you're taking more out of the economy and putting less into the economy. So how can you conclude or do you conclude—do I interpret your statement correctly as expecting a more rapid rate of growth in the 1980's than we had in the 1970's?

Mr. FELDSTEIN. I do not think that the decade is the right period of measurement. When you say 4 percent from here on out, I think

perhaps a useful way to look at it is from the beginning of the recovery.

Senator PROXMIRE. I'm talking about the projections that accompanied the budget itself and they said 4 percent.

Mr. FELDSTEIN. If you start with the fourth quarter of 1982 so that we have last year's actual experience plus the projections that come with the budget, it amounts to 4.3 percent real growth over those 7-years. By comparison, starting at the beginning of past recoveries—that is the crucial point—the average growth over a 7-year period has been 4 percent.

The trouble with the 3 percent figure that you offered is this: whatever the exact figure for real growth from 1970 to 1979 or 1980, you are not looking at comparable periods relative to the business cycle.

What we are talking about is not a sustainable 4-percent growth once you have reached full employment. What we are talking about is coming up at an average rate of 4.3 percent from a deep hole.

Senator PROXMIRE. In 1983 we had a second quarter growth rate of 9 percent, a third quarter of about 7 percent, and a fourth quarter of about 4. It seems to me we're down to 4 percent already.

Mr. FELDSTEIN. Real growth was 4.5 percent in the fourth quarter. That is what we are expecting this year.

Let me be very clear. I do not think one can be confident that the number is going to be 4 percent for the decade. As we said, it is conditional on bringing those budget deficits down.

Senator PROXMIRE. Well, maybe it's too much of the Keynesian influence, the notion that if you have a stimulative policy it tends to accelerate growth in the economy, at least temporarily for several years, and if you have a strained fiscal policy—in other words, if you reduce your deficit, you tax more and spend less, thereby slowing growth. Reducing the deficit is what you and I both want to do and so does the chairman of the committee. We all agree that we should knock the deficit down. He doesn't want to do it with any tax increase, but we all agree we want to reduce the deficit.

My point is, when you do that, hasn't our experience been that you have the effect of slowing the economy. The most dramatic example was World War II when, of course, we had a colossal increase in spending, an enormous increase in spending, and a terrific increase in the growth of the economy. And in periods when we've had a declining Federal spending we've had the economy decline or grow less rapidly.

Mr. FELDSTEIN. Let me make several points. Despite the shrinking of the deficit, one thing that will influence the overall rate of growth for the next 6 years is whether we go through another business cycle. If we go through another business cycle especially a serious one we may end up much lower at the end of that period.

One reason to be hopeful about this is that by keeping inflation under control, and avoiding the go-stop process that caused trouble for the last decade, we may be able to get a higher average rate of real growth.

Second, although the pure effect of shrinking the deficit is to reduce demand, we would at the same time achieve lower interest rates, which we would expect to stimulate more demand through

investment and net exports than we have. I think that this would offset the shrinking of demand coming from reducing the budget deficit.

Finally, over a period as long as a decade, you raise capital accumulation and affect the overall potential and actual growth. By shrinking the deficits we can have more capital accumulation, more introduction of more modern technology, as well as capital deepening, and through all of this I think you could have a higher rate of growth.

I think that the tax changes on the business side and on the savings side that were enacted in 1981 have a potential for giving us a good rate of growth over the decade, if we do not waste it.

Senator PROXMIRE. Well, I hope you're right. I'm just concerned of the possibility that as we come off—you said we have to pay the price of a recession—as we come off of this high deficit, we are somewhat more likely to go into a period of recession, which as you say, would mean slow growth.

Do you agree with Secretary Sprinkel and Dr. Meltzer who will follow you as a witness that the Federal Reserve should hit its annual growth target within 1 percent in each quarter?

Mr. FELDSTEIN. A quarter is quite a short period of time.

Senator PROXMIRE. Let me add just one short note to that. Chairman Volcker indicated that the difficulty with that is that there are times during a quarter when you if you follow that rigidly you can send interest rates right through the roof so you have to use a little discretion and flexibility.

Mr. FELDSTEIN. The principal argument for hitting the targets quarter-by-quarter or month-by-month is that it builds confidence that the Fed is serious about its targets. Again, this year the Fed ended the year with all of its aggregates either in the target or very close to the target, and I would hope that would contribute to investor confidence and financial market confidence about the Fed's behavior.

The argument about hitting the targets—frequently very short-term targets—probably carried more force when monetary targeting was just beginning and there was a good deal of skepticism about the Fed's willingness to hit targets and to do tough things in 1980 and 1981. But I think the Fed has convinced most observers that it is prepared to do tough things. It might be just much too much of a constraint on the Fed to try to do it quarter-by-quarter.

Senator PROXMIRE. Are the stock markets gyrating now because of lack of confidence in the Fed or lack of confidence in Congress' policy to control the deficit?

Mr. FELDSTEIN. I do not think that there is any change in the Fed's policy or in their perceived policy.

Senator PROXMIRE. So there's a lack of confidence in fiscal policy?

Mr. FELDSTEIN. I think that fiscal policy is the big worry on the part of the business and financial community, although again, I do not want to separate monetary and fiscal policy too much because I think that market participants are worried about the problems that the fiscal environment and the exchange rate environment create for monetary policy. Along the same line, we create more

monetary policy uncertainty by the fiscal and exchange rate environment.

Senator PROXMIRE. To what extent and to what degree were the Council of Economic Advisers consulted in the preparation of the President's budget for fiscal year 1985?

Mr. FELDSTEIN. I personally was involved at every step along the way.

Senator PROXMIRE. And your colleagues were involved to some extent?

Mr. FELDSTEIN. They were involved in the sense that I discussed this with them. They were not physically involved with meeting with the President.

Senator PROXMIRE. There are some who argue that only spending increases or decreases have a lasting effect on economy, that it doesn't matter whether that spending is financed through taxes or borrowing. Do you share that view and what's the effect on financing the deficit?

Mr. FELDSTEIN. The impact of spending depends upon how it is financed. If it is financed by borrowing, then it primarily comes at the expense of investment. I say "primarily" rather than "exclusively" because there will presumably be some increase in savings. If it is financed by taxes—again, depending upon the particular form of taxation—it is likely to come much more from consumption.

Senator PROXMIRE. Thank you. My time is up.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you very much, Mr. Chairman.

MAJOR CORPORATIONS HAVING GOOD REVENUES IN 1983

Dr. Feldstein, yesterday Chairman Volcker was here and I asked him questions. I don't have my notes from yesterday, but basically, the major corporations of America are producing much more revenue in the third and fourth quarters than they were anticipating. There was quite an announcement yesterday by General Motors that their fourth quarter earnings were eight times what it was a year ago. These increased earnings will produce more tax revenues to our Treasury.

Do you feel that we can whittle down the deficit by revenues coming in without taxes?

Mr. FELDSTEIN. No. The estimates that the Treasury has made and continually thinks about are that even with the kind of revenue we expect this year, we are going to end up with deficits of over $180 billion for fiscal year 1984.

Senator HECHT. But as earnings increase, what were your projections 1 year ago of the earnings this year?

Mr. FELDSTEIN. Our estimate 1 year ago missed the revenue in fiscal year 1983 by some $3 billion. I should say that the Treasury missed it. They are really very, very accurate in making these calculations. We have built into our forecast of revenue a quite strong economic growth of 4 percent real growth over these next 5 years without any economic slowdown, with revenue roughly rising from about $600 billion in total receipts last year to more than $1,000

billion by 1989. But even so, we anticipate budget deficits of nearly $200 billion.

Senator HECHT. And down the line in 1985 and 1986 you see a continuing with the increases in revenue will not cut it down at all?

Mr. FELDSTEIN. The deficits are obviously much smaller because of this additional revenue than they otherwise would be, and we show substantial increases in corporate income tax receipts. The corporate tax receipts will rise more than 50 percent between 1984 and 1988, but even so we are talking about these very, very large budget deficits.

Senator HECHT. Well, how about every time you have a 1 percent drop in unemployment, $30 billion off the deficit? As unemployment goes down—forget the corporate earnings—what effect will that have?

Mr. FELDSTEIN. You're absolutely right. Every 1 percentage point decline in the unemployment rate or, alternatively, every 2.2 percent increase in the level of GNP reduces the budget deficit by about $25 billion, primarily by bringing in additional revenue. But all of that is built in. That is, we have the unemployment rate forecast to come down to under 6 percent by 1989. We have 4 percent real growth in GNP over the year. All of that and its revenue consequences are already in these calculations. Even more important in terms of the size of the deficit, we have the assumption that interest rates will come down very sharply, and that Treasury bill rates will be almost cut in half between now and 1989. They will be only 5 percent. If that does not happen, every percentage point that the Treasury bill rate, or the cost of financing Government debt, rises will cost us about $25 billion a year in additional outlays by the end of this decade.

Senator HECHT. Well, what if we do as you're suggesting, raise taxes? Business expansion will be curtailed and maybe the employment will not be as your projections, then what would happen?

Mr. FELDSTEIN. First, I am not suggesting either taxes or revenue. I am here as the administration's witness. I am suggesting only two things. One, the budget; and two, these negotiations. However, our belief is that if the negotiations produce a package which reduces the deficit by $100 billion over the next 3 years or more, and if that is combined with greater assurance in the financial markets and by business investors, then this will be just the first step, and there will be more done on the spending side and the revenue side in 1985 to really bring these deficits under control. Then we think that interest rates will be lower, we will have more investment at home, we will have a stronger recovery, and we will have a better path of economic growth.

Senator HECHT. If we were to adopt this, what would you think within 2 years the long-term interest rates would come down to?

Mr. FELDSTEIN. That is too tough. What we are forecasting for the Treasury bill rate, on the assumption that we make this substantial progress now and that is followed by larger cuts in the deficits enacted in 1985, is 7 percent by 1986. That is a decline of about 2 percentage points. Long-range rates, given this reason for reduction in rates, would move more or less in parallel.

Senator HECHT. About 3 weeks ago I was at a National Homebuilders show in Houston and there's a tremendous pentup demand around there for homes and basically the minute the interest rates start dropping you will see a tremendous amount of new construction.

Mr. FELDSTEIN. Exactly. That answers the question you asked before. If we get progress on bringing down the deficits, whether on the revenue side or on the spending side, that is going to have a deep effect in reducing interest rates. What follows will be the realization of potential demand for homebuilding, long-term corporate investment, and business construction—all of that will take place.

Senator HECHT. Thank you, Mr. Chairman.

The CHAIRMAN. I thank you, Senator Hecht.

I think you've probably learned that being the second witness, or third, or fourth witness as we get closer to lunch, the questions get shorter and shorter. It's the first witness that gets the brunt of all the Senators.

Mr. FELDSTEIN. This is my sixth hearing in 6 business days, and I cannot complain.

The CHAIRMAN. I do very much appreciate you coming before the committee today and I want to repeat what I said about your courage in speaking out about deficits. Many of us up here appreciate it. Thank you very much.

Mr. FELDSTEIN. Thank you.

The CHAIRMAN. Next we have a panel composed of Dr. Robert Parry, executive vice president and chief economist of Security Pacific Corp.; and Dr. Allan Meltzer, professor at Carnegie-Mellon University.

Dr. Parry, would you like to begin?

STATEMENT OF ROBERT PARRY, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, SECURITY PACIFIC CORP., LOS ANGELES, CALIF.

[Complete statement follows:]

Written Statement of

Robert T. Parry
Executive Vice President and Chief Economist
Security Pacific Corporation

to the
Senate Committee on
Banking, Housing, and Urban Affairs
February 9, 1984

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present my views to this Committee concerning the economic outlook, monetary policy, and related matters.

More specifically, I plan to comment on the performance of the economy last year. Then I shall review recent stabilization policies, both fiscal and monetary, and comment on policy options for the economy in 1984 and 1985. Thirdly, I intend to discuss prospects for the economy for the remainder of this year and for 1985. Finally, I would like to offer a few comments concerning the stabilization policies required to keep us on a path of growth and lower inflation.

The Economy in 1983

The general performance of the U.S economy last year was excellent, particularly in relation to the overall poor performance of the economy from the end of 1979 through the end of 1982. After getting off to a slow start in the first quarter of last year, economic growth accelerated markedly, and by the end of the year the level of output was 6.1 percent above its recessionary low point. As indicated in Table I, the recovery to date has been only slightly weaker than the average first year of expansion in the previous seven economic upturns.

Most sectors of the economy performed well in the first year of expansion. In spite of relatively high mortgage rates, housing was first out of the starting blocks, and it grew strongly. Housing starts surged from less than 1.0 million units in the first half of 1982 to just under 1.75 in the last half of 1983, and inflation-adjusted spending for residential construction rose 38.2 percent in 1983. Real personal consumption expenditures also rose strongly, up 5.4 percent, led by a surge in spending for durable goods, particularly for automobiles, furniture, and appliances.

A powerful force for growth last year was the switch by businesses from large liquidations of inventories in 1982 and the first half of 1983 to moderate additions to their stocks of goods on hand in the last half of 1983. Inventory levels still are lean; therefore, additions to inventory are likely to be a strong force for growth in 1984.

Two other sectors recorded strong increases last year. Real business spending for equipment rose 18.3 percent, faster than in the first year of recovery for any of the previous seven business upturns except for 1950. This development was surprising because capacity utilization rates were

relatively low and because most observers of the business scene had originally expected an anemic recovery in 1983. Not surprisingly, inflation-adjusted defense spending recorded strong gains in 1983. Defense spending actually has been on an upward trend since 1979.

The remaining sectors of the economy -- business spending for structures, federal government nondefense purchases, state and local government purchases, and net exports of goods and services -- exhibited weakness. Particular weakness was displayed by net exports which fell from an inflation-adjusted value of $23 billion in the final quarter of 1982 to $2.5 billion a year later. The negative trend in net exports began in the fourth quarter of 1980, and it results primarily from the sharp rise in the value of the U.S, dollar in foreign currency markets. Since the third quarter of 1980, the trade-weighted value of the dollar has increased more than 50 percent.

The strong growth of output has had a very favorable impact on the employment situation. Last year employment grew 4.0 million, and unemployment fell 2.7 million. As a result, the unemployment rate fell from 10.7 percent in December 1982 to 8.2 percent in December 1983. Although no one would consider the current level of unemployment acceptable, 1983 at least produced significant movement in the right direction. Also, as indicated in Table I, the improvement in the employment picture in 1983 compares very favorably with the average experience in earlier recoveries.

Inflation represents one of the most impressive success stories of 1983. Last year consumer prices rose 3.8 percent, and producer prices increased 0.6 percent. These numbers are in stark contrast to the double-digit price increases experienced as recently as 1982. As indicated in Table I, the inflation experience of this recovery has been similar to that of the average recovery experience. Also, the information in Table II reveals that most of the major components of the Consumer Price Index recorded lower inflation in 1983, including the previously intractable medical care component.

Interest rates remained relatively high last year, particularly considering the low rate of inflation. In addition, after being flat to down in the first half of the year, they trended upward in the second half. Finally, interest rates were significantly less volatile than they had been in the prior three years.

Several factors help to explain these developments. The economy was growing rapidly, and private credit demands, particularly for consumer credit and mortgages, expanded strongly. Also, the huge federal deficit added greatly to the total demands for credit in 1983. Moreover, the generally accepted view that large deficits will persist for the foreseeable future has probably kept inflationary expectations higher than one would have expected given the excellent performance of prices in the past two years. In addition, the Federal Reserve seemed to be more concerned about the re-emergence of inflation than it was in the past, and, as a result, monetary policy was more stringent than was the case in the first year of earlier recoveries. Finally, the monetary authorities paid less attention to the growth of the monetary aggregates last year and focused

more on controlling the level of interest rates. This development explains in part the significantly reduced volatility of rates last year.

Stabilization Policies

A review of stabilization policies in recent years indicates that both fiscal and monetary policies have played important roles in ending one of the longest and most severe recessions of the postwar period. Such a review also indicates that the mix between fiscal and monetary policy has been far from ideal with fiscal policy pursuing a course that is too stimulative and, in response, monetary policy following a path that is more restrictive than is in the long-term interest of the economy. To date, this "mix problem" has not produced significantly adverse effects on the recent performance of the economy, although it has generally played a destructive role for more than twenty years. Unfortunately, it appears as though the "mix problem" will intensify in the years ahead unless steps are taken in the very near future. Failure to take these steps may begin to affect the performance of the economy as soon as the second half of this year and could produce significant impacts on the economy in 1985.

Fiscal Policy

As an economic stabilization tool, fiscal policy can be viewed from a number of perspectives. Three popular ways of viewing the course of federal budget policy are in terms of the unified federal budget, the high-employment budget, and federal outlays as a proportion of the nation's output of goods and services. Not surprisingly, all three viewpoints support the thesis that fiscal policy has been too stimulative and could become more of a problem in future years.

The unified federal deficit has been in deficit in 23 out of the past 24 years with no prospects of a surplus in sight. Just in the first four fiscal years of this decade, deficits have totalled $423.5 billion and off-budget outlays over the period add another $64.9 billion to the red ink. This year the deficit will likely come in at close to $180 billion, down slightly from fiscal 1983's $195.4 billion. Estimates for fiscal years 1985 through 1989 vary greatly, but the Congressional Budget Office estimates that the deficits would be staggering if no actions are taken to rein in spending or raise revenues.

Viewed differently and to provide perspective, from 1947 through 1981, federal budget deficits as a percentage of gross national product exceeded 3 percent only twice, in 1948 and 1976. However, in 1982 the number was 3.7 percent, 1983 6.1 percent, and probably close to 5 percent in the current fiscal year. From 1984 through 1989, the percentage probably will decline further, but it could easily remain too high to permit a healthy performance of the economy.

Most economists question the use of the unified federal budget as a measure of economic stimulus or restictiveness. The unified budget can be a misleading indication of fiscal policy because it also reflects the effects of cyclical changes in economic activity. In contrast, the high-employment budget may provide a better perspective on fiscal activities. The high employment deficit -- or structural deficit as it is more

often referred to these days -- rose from about $20 billion in fiscal 1981 to approximately $100 billion in 1983. In this fiscal year, the structural deficit will expand further, and as a percentage of GNP it will be one of the largest in the last 30 years. Greater s imulus for an economy that already has a strong head of steam underway is dangerous policy. The structural deficit should be narrowed significantly as soon as possible.

A third way of viewing the recent course of fiscal activities is in terms of federal outlays as a proportion of the nation's GNP. From 1960 to 1976, the proportion of federal outlays on a national income accounts basis to GNP trended upward from 18.4 to 23.0 percent, but it then fell steadily to 21.1 percent in 1979. It then rose each year to 25.0 percent in 1983.

The absolute level of the ratio is much too high. While the analysis of federal outlays to GNP does not directly provide information on how restrictive fiscal policy is, it does illustrate a concern shared by many economists. High federal outlays relative to the rest of the economy is viewed by many as a threat to the private sector and also a factor contributing to slow growth in productivity and to inflation.

Monetary Policy

The monetary authorities pursued an expansive policy from mid 1982 through mid 1983. The monetary aggregates grew rapidly, and interest rates fell sharply. Such a policy was appropriate considering that most of the period coincided with a long, severe recession. Some analysts question the conclusion that policy was expansive during this period, citing the effects of financial deregulation and a resulting weak performance of velocity -- the ratio of GNP to money -- as invalidating such a conclusion. Although studies of this issue are by no means conclusive, most seem to support the conclusion that financial deregulation did not greatly add to the growth of the narrowly defined money supply (M1). As a matter of fact, the net effect of the introduction of money market demand accounts in late 1982 and super NOW accounts in early January of last year probably was to slow the growth of M1.

Thus, the strong growth of money appears to have resulted from two influences. First, the monetary authorities were consciously attempting to stimulate a declining economy. Second, the quantity of money demanded by the public was increasing as a result of, among other things, the sharp fall off of interest rates that occurred over the period. The failure of the large decline in interest rates to stimulate the market for goods and services -- or stated differently, the failure of velocity to rise -- during this period does not yet seem to have been explained adequately.

Since the middle of last year, the monetary authorities have cinched up a bit on the credit reins. From the middle of 1983 to the end of the year, M1 grew very little, and short-term interest rates, most significantly the federal funds rates, edged upward. This move on the part of the Fed to tighten just six months into the economic recovery is unprecedented. It seems to indicate that the monetary authorities are indeed serious about bringing the long-term rate of inflation down. In the past, particularly during the 1970s, anti-inflation rhetoric was always more apparent than actions to reduce the rate of inflation.

Another interesting monetary policy development was the decision by the Fed in October 1982 to reduce its focus on M1. Accordingly, the monetary authorities paid more attention to the broader aggregates. Perhaps more significantly, they focused more directly on interest rates and on other indicators of economic performance. The reluctance of the monetary authorities to focus narrowly on M1 is understandable. First, they were concerned that the financial innovations of 1982 and early 1983 would reduce the analytical significance of M1. Secondly, they were puzzled by the failure of velocity to grow in 1982 and early 1983.

In 1984, the Federal Reserve may encounter some difficulty hitting its targets for the monetary aggregates. As discussed later, we expect nominal GNP to rise approximately 10 percent; thus, the velocity of M1 will have to increase 4 percent for the Fed to hit the midpoint of its 4 percent to 8 percent range in 1984. Furthermore, the velocities of M2 and M3 must increase by a percentage point or so in order for those aggregates to stay within their respective targets.

In the second year of the last three recoveries, M1 velocity rose by 2.4 percent to 2.8 percent.* In other words, if history is a guide, M1 is likely to come in above the midpoint of the Fed's target, but it is likely to stay within the target range for the year. M2 and M3, however, experienced velocity declines during the second years of the last three recoveries. Thus, using these rules of thumb, if nominal GNP does grow by 10 percent, M2 and M3 would be outside their target range of 6 percent to 9 percent.

Due to the prolonged decline of velocity during the last recession, it is very possible that the growth of velocity next year will be stronger than history would suggest. If that were to occur, the Fed could more easily hit the midpoint of its M1 target, and M2 and M3 could end up the year in the upper half of their respective targets instead of above them. In either case, however, it appears that the Fed would have an easier time keeping rates lower if it weights M1 more heavily than currently in its policy deliberations.

An important question, then, is which aggregate the Fed will concentrate on in 1984. It would appear that M1 will get increasing weight as we move through this year. There are three good reasons for this shift in focus back to M1. First, velocity is again displaying more normal cyclical behavior. Second, as mentioned previously, following M1 ought to provide more latitude for lower rates in 1984. Third, I doubt that the monetary authorities are comfortable with their knowledge about how to interpret the broader aggregates, nor how to control them.

My basic assumption about monetary policy for 1984 and also for 1985 is that the monetary authorities will resist a cyclical upturn in the rate of inflation. They will do this for several reasons. First, they probably expect inflation to pick up in 1984, and they certainly know that inflation typically rises in the third year for those cycles that lasted more than two years. Second, Chairman Volcker and other representatives of the Federal Reserve have made it perfectly clear on numerous occasions that fiscal policy is too stimulative. Finally, the monetary authorities

*The 1980-81 recovery is not included because it only lasted one year.

realize that if foreigners were to question the resolve of the Fed to pursue an anti-inflationary policy, capital outflows would be massive. The value of the dollar in foreign exchange markets would plummet, and a major inflationary influence would be introduced into the U.S. economy.

For all of these reasons, I expect the monetary authorities to pursue policies in 1984 and 1985 that are designed to prevent a large, cyclical upturn in the rate of inflation. As is discussed in the next section of this statement, these policies, combined with a fiscal policy that is expected to be very stimulative, will leave significant imprints on credit markets and the economy, particularly in 1985.

Prospects for the Economy

1984

As indicated in Table III, this year is expected to be another good year for the U.S. economy. The output of goods and services produced is forecast to rise 4 to 4.5 percent over the course of the year, and by the end of 1984, the level of economic activity will be 10.8 percent above its recession low point.

Most sectors of the economy will expand rapidly. Consumer spending will remain strong, and spending for residential construction will register a sizable increase. Greater spending by businesses for plant and equipment will provide follow-through to the expansion. Growth will also result from additional inventory accumulation, as businesses attempt to get stocks into a better relation to sales. Finally, federal spending, particularly for defense, will rise rapidly.

The remaining sectors of the economy are expected to be weak. Although the fiscal position of state and local governments is improving, spending by these government entities is not likely to rise very much this year. Net exports of goods and services will decline further in 1984, because the value of the dollar is expected to decline only slightly.

Continued expansion of the economy will result in further improvement in the employment situation. Employment is expected to rise 3.5 million, and the unemployment rate should end the year between 7 and 7.5 percent. The best inflation news is behind us, but the expected pickup in the rate of inflation should be moderate. By the end of the year, consumer prices should be rising at a rate of close to 6 percent.

The general business climate this year should produce a sharp gain in corporate earnings, and the growth of employment combined with moderate gains in wage rates will add significantly to personal income. At the same time, however, strong spending by both businesses and individuals is expected to result in greater demands for credit from the private nonfinancial sector of the economy. Federal requirements for credit will remain very large, although state and local governments will record a sizable surplus. The monetary authorities are expected to be moving toward a somewhat more restrictive stance by the second half of this year. Thus, interest rates are likely to be trending upward in the second half of this

year. By year end, interest rates are forecast to be 50 to 100 basis points above today's levels.

1985

From today's perspective, caution lights should be turned on for the economy in 1985. If significant progress is not made in closing the gap between federal government spending and revenues before 1985, the imprint on the 1985 economy could be significant. More specifically, large stimulus from fiscal policy is likely to be accompanied by a restrictive, countervailing stance by the monetary authorities. The result is likely to be higher interest rates and a significant slowing in economic activity. As indicated in Table III, the growth of output is expected to slow to a gain of only 1.7 percent. Weakness in the economy is likely to develop and center in the credit-sensitive sectors of the economy.

With the pace of economic activity slowing so markedly, further improvement in the employment picture would not be likely in 1985. As a result the unemployment rate actually would move up slightly. The rate of inflation would move up but not by much as a result of the restrictive stance of monetary policy and the resulting slowing of the pace of economic activity. Early in the year interest rates would be higher than they are expected to be at the end of 1984, but by the second half of 1985, the pronounced slowing in the pace of economic activity could permit a small decline in interest rates.

Concluding Comments

An important objective for the stabilization authorities is to ensure that inflation trends downward in the remaining years of this decade. At this stage of the business cycle, such an objective makes it imperative that actions be taken to limit the inflationary pressures that could develop as the economic expansion matures. More specifically, it is essential that the peak in inflation for this business cycle be far below that of recent past cycles.

For the monetary authorities, a low inflation rate objective means that the Federal Reserve should gradually attempt to reduce the growth of the monetary aggregates. The aggregates grew very rapidly in the past year and a half, although this growth was desirable considering its business cycle context. This year the Federal Reserve should strive to achieve its objectives of slower growth of the monetary aggregates. In 1985, it probably will be necessary to reduce the growth rates of the aggregates even further.

Achievement of stabilization objectives are being greatly complicated by fiscal policy. However viewed, fiscal policy is and will likely remain too stimulative unless corrective actions are taken soon. The deficit should be trimmed by a combination of expenditure reductions and tax increases. My own personal preference would be to emphasize expenditure reductions in an effort to reduce further the size of federal outlays relative to GNP. It is difficult to recommend specific cuts, but every item in the budget should be considered a candidate for reduction, including defense and entitlements. To the extent that tax increases are

needed, I would favor higher taxes on consumption. Every effort should be made to avoid raising taxes in a manner that would reduce incentives to work, save and invest.

Failure to bring future deficits down significantly will produce one of two outcomes, neither of which is acceptable. First, if the Federal Reserve loses its resolve to pursue low rates of inflation in the face of massive federal budget deficits, the debt will be monetized, and the seeds of future high rates of inflation will be planted. The painfully-won inflation successes of the past couple of years will be lost. Unfortunately, history provides ample evidence that this outcome is possible.

Second, if the monetary authorities retain their resolve, the clash between massive Treasury requirements for funds and rising private needs for credit will push interest rates to lofty levels. The result will be that the credit sensitive sectors of the private economy will suffer, and the proportion of private saving commandeered by the U.S. Treasury will rise. Insufficient private investment will take place, and the growth of productivity will suffer. High interest rates will push the value of the dollar in foreign exchange markets even higher, and the trade deficit will worsen. What we will end up with is an economy that is too heavily oriented toward government spending and spending for current consumption and too little investment in plant, equipment, and housing.

* * * * *

Table I

Selected Economic Indicators
(Percentage changes)

	1983*	Postwar Average**
Gross National Product (constant 1972 dollars)	6.1	6.5
Employment	3.5	2.1
Unemployment	-19.3	-8.1
Consumer Prices	3.3	3.2
90-day Treasury Bill Rates	11.3	27.1

*Percentage changes from the fourth quarter of 1982 to the fourth quarter of 1983.

**Average percentage changes for the first year of the past seven postwar recoveries.

Table II

Selected Components of the Consumer Price Index
(Percentage changes)

	1980*	1981*	1982*	1983*
All Items	12.4	8.9	3.9	3.8
Food & Beverages	9.3	4.3	3.2	2.8
Housing	12.4	10.2	3.1	2.5
Transportation	13.8	11.0	1.7	4.5
Medical Care	9.5	12.5	11.0	5.8

*Year ending in December.

Table III

Prospects for the U.S. Economy
(Percentage Change in Constant 1972 Dollars)

	1982*	1983*	1984*	1985*
Gross National Product	-1.7	6.1	4.4	1.7
Consumption	2.5	5.4	3.5	1.5
Durables	6.2	14.3	6.7	-2.5
Nondurables	0.6	4.7	2.1	1.9
Services	2.9	3.2	3.5	2.5
Investment	-6.8	16.9	6.7	1.0
Business Fixed	-9.0	11.5	7.3	4.7
Residential	3.0	38.2	4.6	-11.2
Change in Inventories**	-22.7	7.5	15.8	15.4
Government	3.5	-2.2	4.3	3.4
Federal	8.6	-6.0	7.4	5.7
State & Local	0.1	0.6	2.3	1.8
Net Exports**	23.0	2.5	-0.8	-0.8
Final Sales	0.2	4.0	3.9	1.8

*Percentage changes from the fourth quarter of the preceding year to the year noted.

**Changes in Dollars.

The CHAIRMAN. Thank you, Dr. Parry.
Dr. Meltzer.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Mr. MELTZER. Senator Garn, it's a pleasure to be back here. I have to start with a question which I direct to you. It is not a rhetorical question. What is the monetary policy of the United States? Do you know, Senator Garn or Senator Hecht? Do any members of the Banking Committee know? Or do I know, who studied policy for 25 years? The answer is no. No one knows.

[Complete statement follows:]

What Is Our Monetary Policy?

by Allan H. Meltzer

What is the monetary policy of the United States? No one knows. The Federal Reserve does not know because it does not have a policy that looks ahead more than a few months, and it avoids any attempt to develop one. It announces annual targets but does not adopt procedures capable of achieving them. Part of the administration frets publicly about monetary policy from time to time, but the administration has no authority to develop a monetary policy. The Congress has constitutional responsibility for money, but it is unwilling to require the Federal Reserve to announce and implement a long-term policy. It seems content to let the Federal Reserve announce its objectives at public hearings and then ignore them. Congress neither requires the Federal Reserve to achieve its announced targets nor to explain why there is little relation between what the Federal Reserve says and what it does.

Past history gives little reason to believe that the announcements are a reliable guide to what the Federal Reserve will do. Targets or objectives for money growth have been announced since 1975. They are rarely achieved. Although the Federal Reserve staff has claimed publicly that it can hold money growth within a narrow band around the announced growth rate, the Federal Reserve has not done so. Table 1 shows the difference between past announcements of money growth and reported or actual money growth.

The table suggests that the Federal Reserve has an inflationary bias. The average growth rate of money (M1) -- currency and checking deposits -- is above 7% for the eight year period. Federal Reserve errors are typically positive and average about 2 to 3 percentage points per year. As long as the Federal Reserve behaves as it has, inflation will be a recurring problem. Variable

rates of inflation and periodic efforts to slow inflation will continue to impose an unnecessary burden on the economy.

Table 1

Targets for M_1 Growth 1976-1983

Year ending in 4th Quarter	Target Range	Target Mid-point	Actual or Reported	Error
1976	4.5-7.5%	6.0%	5.8%	-0.20%
1977	4.5-6.5	5.5	7.9	+2.40
1978	4.0-6.5	5.25	7.2	+1.95
1979	3.0-6.0	4.5	7.4	+2.90
1980	4.0-6.5	5.25	7.2	+1.95
1981	6.0-8.5	7.25	5.1	-2.15
1982	2.5-5.5	4.0	8.5	+4.50**
1983	1st half 4-8 2nd half 5-9	6.5*	9.6*	+3.10

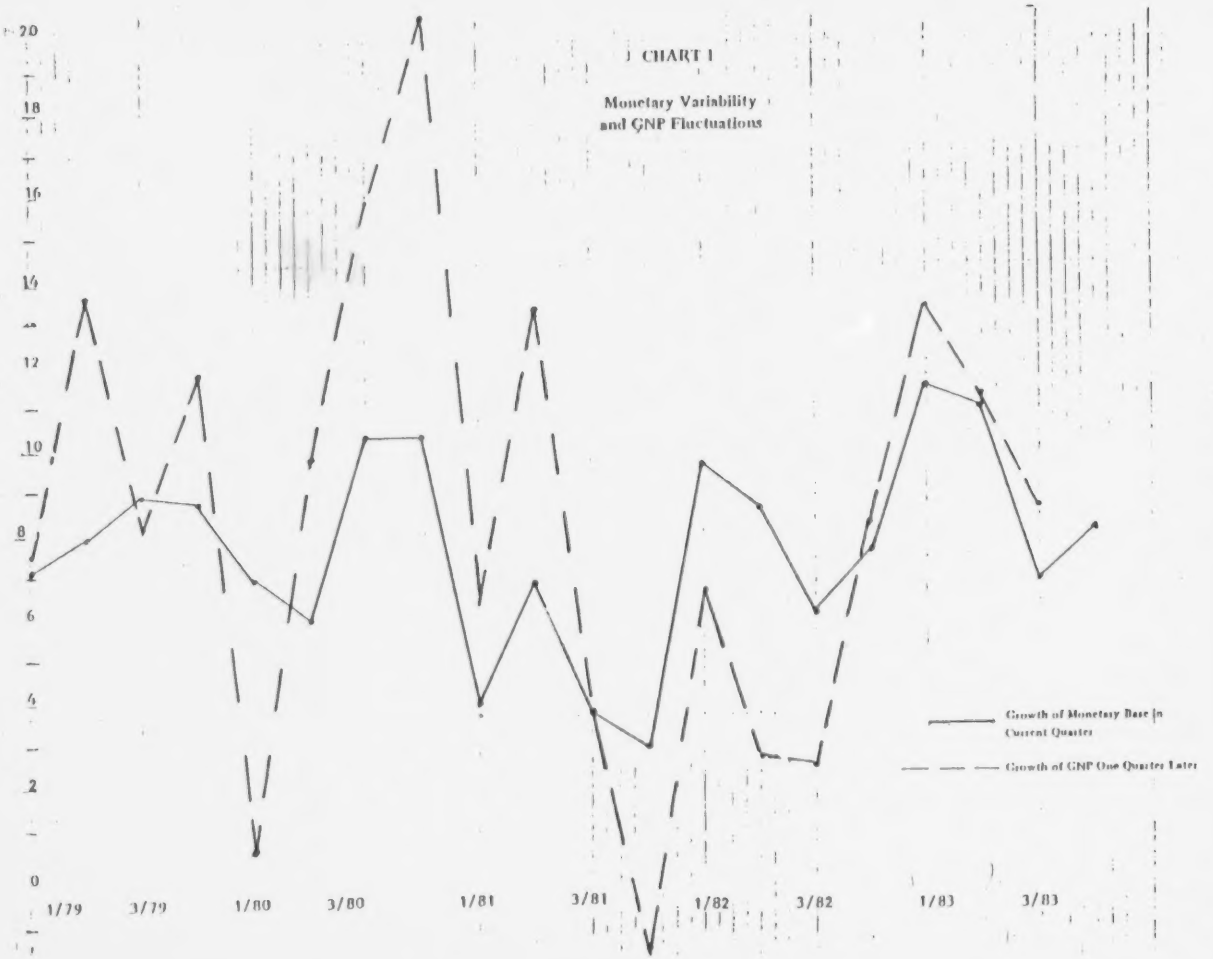
* 1st half mid-point 6.0, actual 13.8;
2nd half mid-point 7.0, actual 5.4

** target abandoned in October; error for first three quarters is 2.8 at annual rates

Sustained periods of money growth at the average rate of 1982 and 1983, if continued, will bring inflation back to the level of the 1970's. The recession of 1981-2 will have no more than a temporary effect on the rate of inflation. The public will have paid the cost of recession without receiving any durable benefit. The widely noted decline in inflation to less than 4% in 1983 will be followed by higher inflation just as were the relatively low rates of inflation in 1967, 1972 and 1976.

CHART 1

Monetary Variability and GNP Fluctuations



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The absence of a policy is costly. No one knows from quarter-to-quarter or year-to-year whether money growth will be adequate to sustain expansion, so excessive that it restores inflation to previous rates or so low that we experience another recession. No one can look ahead with confidence that monetary policy will contribute to stable growth for the next several years or even for the next several quarters.

The jagged pattern of recent money growth has left its mark on the growth of GNP. Chart 1 shows that quarterly changes in the growth rate of the monetary base -- bank reserves and currency -- are followed within a quarter by similar changes in the growth rate of nominal GNP. The monetary base is the amount of money produced by the Federal Reserve. It is completely controllable if the Federal Reserve choses to do so or is required to do so by law.

[Insert Chart 1 about here]

Chart 1 does not suggest that Federal Reserve action is the only determinant of GNP growth. GNP growth is influenced by many other factors. The chart shows, however, that for the past three years every peak or trough in base growth has been followed within one quarter by a local peak or trough in GNP growth.

Federal Reserve spokesmen have told Congress and the public that money growth has little relation to GNP. They have offered explanations of the reasons why this is so. But they have given no evidence. Chart 1 suggests, contrary to these claims, that the relation has become closer in one respect. The lag between growth of the monetary base and the growth of GNP appears to be shorter than in the past and more consistent. All recent turning points in base growth have been followed within a quarter by turning points

in GNP growth. The magnitude of the relative changes in base and GNP growth vary, however, so quantitative forecasts of quarterly GNP growth based on this relation are no more reliable than other forecasts of quarterly GNP growth.

Chart 1 shows that the excessive variability introduced by destabilizing actions of the Federal Reserve has increased the variability of the economy. Increased variability raises the risk that the economy bears, raises the rate of interest, lowers investment in long-term capital and increases interest payments on the government debt. Estimates prepared for the Treasury Department suggest that the increased variability of unanticipated changes in money growth raised short-term interest rates in 1980 to 1982 by three percentage points. Variability declined in 1983, so the risk premium in short-term rates is now smaller than in the previous three years. But, the risk premium remains higher than in the sixties or seventies reflecting heightened uncertainty about future money growth.

My calculations suggest that the excessive variability of money growth raised short-term rates in 1983 by 2 to 2-1/2 percentage points and kept long-term rates more than one percentage point above the level they would have reached if variability returned to the level of the 1970's.

Spokesmen for the Federal Reserve and some administrative officials try to explain the present levels of interest rates by referring to budget deficits. I do not know a single study showing a relation between deficits and interest rates for the United States. The Congress should ask for evidence to support these claims.

I have commented on the problems posed by persistent deficits in previous hearings and elsewhere, in the past, so I will summarize two main points here.

First, a principal problem with our fiscal policy is not the deficit per se. It is the high rate of consumption spending encouraged by government and sustained by government transfer payments and spending for defense. These programs shift resources from investment toward consumption. Second, deficits become inflationary and raise market rates of interest when they are financed by the Federal Reserve. No one knows how much of the deficit the Federal Reserve will finance because, as I have said, the Federal Reserve does not have a policy. But if the Federal Reserve continues to attempt to control interest rates, they will, from time to time, finance part of the deficit by inflating.

The deficit is not the only excuse offered by the Federal Reserve. Some, including presidents of two of the Federal Reserve banks, blame deregulation of the financial industry for the variability of money growth and current and past levels of interest rates. Such statements are difficult to reconcile with research by the staff of the Federal Reserve Bank of San Francisco and the staff of the Board of Governors, the latter published in the May 1983 Federal Reserve Bulletin, showing that M1 has not been much affected by the introduction of the new types of deposit accounts.

The main cause of monetary variability is not deregulation or deficits. It is the failure to have a stable, non-inflationary monetary policy. No one should expect to restore stable growth with low inflation until the Federal Reserve adopts a policy and develops procedures that achieve the policy it adopts. Congress has constitutional authority for monetary policy. It should not permit the Federal Reserve to operate as it has.

Hearings such as this are not an effective procedure for imposing monetary discipline. The comparison of announcements made at past hearings with actual

policy, in Table 1 above, shows little relation between words and deeds. What point is there to having the Federal Reserve announce plans or intentions that bear little relation to what they do?

I believe the Congress must find a more effective procedure for monitoring the performance of its agent, the Federal Reserve. Congress should require the Federal Reserve to set a target for monetary growth. If they miss the targets by more than one percentage point, the chairman and all members of the Board of Governors should be required to offer their resignations to the President of the United States, who appoints them, with an explanation of the reason for the discrepancy. The President would have the right to accept the explanation, and with it the responsibility for the result of the policy, or accept the resignations.

This proposal removes a principal obstacle to more stable, more reliable monetary policy -- the absence of accountability. It ends the separation of authority and responsibility and gives an incentive to the Federal Reserve to improve its performance. Without improved performance, we will continue to pay the costs imposed by variable and uncertain monetary actions and the absence of a coherent monetary policy.

The CHAIRMAN. Thank you, Dr. Meltzer. I plead guilty to neither being an attorney or an economist. My business or my background is in business. My degree in college was in banking and finance and I don't disagree with a lot of what you said about the Fed and I think everybody generally agrees that they have been rather up and down over several years in hitting their targets.

But I am puzzled that you don't seem to relate that to fiscal policy. I understand what you said about spending and all of that, but I firmly believe if I made you Chairman of the Federal Reserve Board tomorrow, with all that brave talk—and Beryl Sprinkel the same thing and other economists—in the 9 years I've been here I've had the opportunity to hear all the world's best economists—Democrats, Republicans, liberals, conservatives, all different philosophies—the one thing that has been consistent in those 9 years of testimony is that virtually all have been wrong, with all their fancy econometric models at the beginning of the year and I guess they hope we won't look again at the end.

CAN THE FEDERAL RESERVE HIT THE 1-PERCENT TARGET?

All I see is a little commonsense and being willing to listen, but your suggestion that members of the Federal Reserve Board offer their resignations if they miss their targets by more than 1 percent, that we ask academic economists if they err by a margin of 1 percent they be required to give up their tenure and submit their resignations to the president of their university; and Senator Hecht and I, if we do it, we submit our resignations to our Governors in our States. I'm being serious about that question.

Whatever we may agree about the ups and downs, are you really serious that if they miss by more than 1 percent with anything that is as imprecise as trying to judge those monetary aggregates on a monthly or quarterly basis that they should submit their resignations? Nobody would perform in any job of this country. Everybody would have to quit.

Mr. MELTZER. May I respond?

The CHAIRMAN. Oh, yes.

Mr. MELTZER. Let me make three points. First, it is annual, not monthly or quarterly that I'm talking about. What we need to do is have confidence in the annual targets.

Second, the staff of the Federal Reserve has claimed publicly that they can hit those targets within 1 percent. If they can't hit them within 1 percent, what is the point of giving you a moderate range of 4 to 6 percent, as they have in the past. If they know they aren't going to come within 4 to 6 percent, those statements are meaningless.

What confidence can you or others have in their statements if in fact you can't believe them? That's what you just said in your statement to me. You don't believe they can come within 1 percent of the target.

The CHAIRMAN. I certainly don't.

Mr. MELTZER. Third, we want to ask why can't they come within 1 percent of their targets? The answer is because they don't choose an aggregate that they can control. They can control the size of their balance sheet. Senator, I would be willing to take the gamble

that I would control the size of my balance sheet and you can control the size of your balance sheet and the Federal Reserve can control the size of their balance sheet within 1 percent on a monthly basis, but I only ask them to do it on an annual basis.

The monetary base represents the size of the Federal Reserve's balance sheet. Ninety percent of the monetary base is securities the Federal Reserve purchases on the open market. All they have to do to keep the size of that balance sheet within the limit is to stop their purchases of securities or hold them to the rate which is consistent with their target. The balance sheet will come into line.

That's really all I'm asking them to do. It is doable. They know it's doable and I believe it is doable. Now I would like to take up one last point.

Why are the forecasts so bad? I wouldn't want to be held to a forecast from quarter to quarter. I think people are wrong to base their decisions on those forecasts. The reason is shown by the chart in my paper. People are forecasting what the monetary growth is going to be. They have no idea. You can hear witness after witness. Some will tell you they think the monetary growth is going to be high in the spring and low in the fall. Some will tell you the Federal Reserve is going to have expansive policy through the years and others think that it's going to have no growth. They don't know.

One reason—not the only reason, but one main reason why those forecasts are so bad is because nobody knows what monetary policy is going to do. Yet every forecaster has to make a judgment when he makes his forecast about what the deficit is going to be, what fiscal policy is going to be, whether we're going to have instability in foreign exchange markets, and what money growth rates are going to be. Those are judgments people have to make. Forecasts depend upon those judgments. Those forecasts are unreliable in large part because we live in an uncertain world.

My complaint is, it is more uncertain than it needs to be. Congress has responsibility for reducing that uncertainty and I believe has failed to do it.

The CHAIRMAN. I agree with you. We can have more uncertainty than we do. Again, to blame the lack of forecasting ability on the basis that the Fed is uncertain, then why is it from that same data I get a spread from noted economists, well known, that are so vastly different in their forecasts from that same data. I think that's trying to push the blame, just like everybody is trying to push the blame—I know I've seen charts—I can produce a chart to prove anything we want.

Mr. MELTZER. But I'm not trying to prove anything. What I'm asking is that using anybody's forecast in advance, the pattern shows these peaks and troughs in the last 3 years. That means that the acceleration and deceleration cycle continues. Why would any reasonable forecaster have predicted that particular pattern? It looks like the path that would be followed by a drunk wandering from lamppost to lamppost. It doesn't look like a sensible monetary policy, and it isn't.

The CHAIRMAN. I can show you charts where the forecasts were off when you didn't have that kind of pattern. I can also show you that when we had stable fiscal policy in this country during periods of time that the Fed was hardly existent. Nobody knew who the

Chairman of the Fed was. The Board was not really evident publicly.

So what I'm trying to tell you is that it's not my academic background but my commonsense that tells me these two have to be coordinated, and the Fed's job would be a lot easier if we had some responsibility on the Hill. It would be a lot easier for them to hit their targets and for them to be responsible and not try to put all the blame on them for this irrationality without similar comments about the fiscal policy of this country.

Mr. MELTZER. May I just say that I agree with you completely, that the economy would be much improved if the fiscal policy in this country were better, but that would require no further increases in taxes but cuts in spending.

The CHAIRMAN. But you would agree the Fed's job in hitting their estimates would be a much easier job if we had a more stable fiscal policy?

Mr. MELTZER. No. The Fed can control the base just as well under any set of fiscal circumstances that you can describe within the range that we have been talking about. There are some limits to that, but they are not really critical for us.

What I am saying is that the economy's performance would be better if there were less uncertainty about deficits and about who is going to pay and who's going to benefit from Government spending.

RELATIONAL ISSUE OF DEFICITS AND INTEREST RATES

The CHAIRMAN. Well, I think the record shows that the Fed's performance is better too and has an easier job. There aren't nearly as many variables for them to adjust as well. Are you saying here that you don't know of a single study showing the relation between deficits and interest rates in the United States. I don't know either. I don't know of a single study.

But again, I suppose this repels people who are trained in a particular discipline more than anything else to have an amateur sit up here and say, but my commonsense tells me something different. That's like the evidence in criminal cases. You know damned well the guy committed the crime but you can't prove it, and that's what you're telling me. You're telling me you can't show a study that shows there isn't a connection, but there is nothing I believe more firmly than that there is a very definite and significant connection—and you can't convince me with all the charts in the world—that borrowing 70 percent of the net domestic savings of this country doesn't crowd out money available for automobile loans and everything else and tend to drive up interest rates.

Mr. MELTZER. Well, let me just——

The CHAIRMAN. Let me finish. I'll give you plenty of opportunity to reply. And I also over the last 9 years have had something to do with the financial markets of this country from the standpoint of rules and regulations about how the community works and how that should be shaped and I have a great deal of contact with not only economists but working money managers in this country, and almost without exception, they will tell me that the reason real interest rates have stayed so high with relation to inflation has noth-

ing to do with a chart showing deficits, but they believe it does. The psychology—if I haven't learned anything else about economics sitting on this committee, it's how important psychology is, and they don't believe politicians. They don't believe a President because every President comes in and says that by the end of his first term he's going to balance the budget. Every Congressman and Senator is for reduced deficits and balanced budgets. How many decades do they have to be lied to? They don't believe it now. Until there are structural changes made in the authorization laws and in the entitlement programs that prove to them that interest rates are going to stay up.

Now this is the practical side of it, not the models, not the economic training, and that is reinforced in my mind every day. There's never a day that goes by that I don't have contact with some of those people that are out there working in the real world, not in Congress and not in academia, but in the real world, and that's what they're telling me.

So there is—all the economists in the world can tell me there isn't a study that shows there is a connection between deficits and interest rates, but there is, and I believe that as much as I am sitting right here. From a practical, commonsense world of it, there is.

Mr. MELTZER. I agree with one statement, so as not to be contentious about everything. I would say I certainly support and agree with your statement that we must cut the entitlement programs. What is far more important than this issue about deficits and interest rates is the question about whether we are going to allocate resources toward investment growth and the future of our children and our grandchildren or whether we're going to continue to run large budget deficits which primarily support consumption spending now at the expense of the future.

That's critical and we will not get the fiscal problem resolved by arguing whether deficits affect interest rates or don't affect interest rates. We agree on the bottom line—I think you and I—which is that the important thing to do is to cut the deficit mainly by cutting consumption spending financed by the Government, that is entitlements and to some extent military spending.

The CHAIRMAN. We do agree on that.

Mr. MELTZER. So we need not argue about the other.

Mr. PARRY. If I could make a comment on this issue, I think the fact that you don't see a study equating upward pressures on interest rates and the deficit is a correct observation, but it's probably irrelevant for what we're dealing with today.

In the past when we have had large deficits we have had expansive monetary policy which has often coincided with periods of economic weakness and interest rates in fact went down. In periods of expansion, because of the tax structure and the way expenditures have been growing, there was an automatic narrowing of the deficit.

The problem we face today is unique. It's very different from the past. We've got a situation, as indicated in the President's economic report and the CBO's recent report, where the deficit is huge on a structural basis and will become larger as time goes on.

At the same time, we have to believe—at least it's my own belief—that the Federal Reserve will be more restrictive this time, and I think the combination of those two factors makes your concerns very real concerns and makes the historical fact of a lack of correlation between the deficit and interest rates completely irrelevant to the discussion.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Mr. Meltzer, I enjoyed your testimony and I congratulate Chairman Garn for getting people who are not afraid to speak up.

Mr. MELTZER. Thank you.

Senator HECHT. I've got a couple questions. You're a professor at Carnegie-Mellon University, but you write in such a practical manner that it's very enlightening to hear a professor talk practically. I've asked the same question often of Chairman Volcker, but I might just give you one simple explanation. I haven't been here very long. I've only been here 1 year.

If we had a complete monetary policy that everything would be right down the line so everybody would know exactly—there would be 10,000 people in Washington out of work the next day if that would happen. There would be no need for all the economists in Washington.

Mr. MELTZER. That would be an improvement.

Senator HECHT.

Probably one of the best explanations of the problem of spending cuts was from Senator Tower not long ago when he said everybody is talking about cutting the military, cutting the Pentagon, but if the Pentagon ever mentions closing a military installation in some Congressman's district all hell breaks loose. So Senator Garn and I agree that you have got to cut spending. The only problem is under our constitutional way it's not that easy sometimes. Anyway, if you have some material from time-to-time I would appreciate you sending it to me.

Mr. MELTZER. Thank you, Senator. Let me say that I share your view. The problem with deficits is, of course everybody is in favor of closing the deficit gap but we all have different means by which we want to do it. That's of course the nature of most political problems. There are some who would like to see it closed by taxes without any cuts in spending and some, like me, who believe it's in the interest of the country to do it principally by cutting spending. Some people would find themselves inbetween.

FOUR BUDGET ITEMS CAUSE 80 PERCENT OF THE DEFICIT

But it's well known that 80 percent of the deficit falls within four items of the budget and we're not going to get substantial cuts unless we cut those four items.

Senator HECHT. Thank you, Mr. Chairman.

The CHAIRMAN. Let me assure you, Dr. Meltzer, that I don't want you to resign if you miss your estimates and the point I want to get back to there is that I feel very strongly that the worse thing we could do—whatever the Fed's performance is—is not to turn the henhouse over to the wolf. We've had examples on this committee where we were not only trying to dictate that they meet their tar-

gets but that we set them for them, and we sat before this committee when Arthur Burns was still Chairman of the Fed and suggested we had monetary targets, as I remember, they were in the double figures, something like 13 to 16 percent. Arthur Burns sat there and said, "Now, Senators, you know better than that." And I would hate to think from 8 years ago if Arthur had yielded to that or Congress had passed a law requiring that, what the inflation rate would be, because the general tendency of this body is to flood the market with money and constant demands.

Yesterday was an exception. Normally when Volcker is here the demands of the majority of the members of this committee is to increase the money supply. So that's why I was digging into you about having them resign if they didn't get within 1 percent. They may not have done the job that you and I would want, but I would hate to have turned over that responsibility. And I want you to consider that. Whatever your faults with the Fed are, if you really want to turn over jurisdiction or even a threat of resigning and all of that to the Congress where we have failed so badly in fiscal policy and when the evidence is overwhelming that our advice to the Fed would only be one way, a greatly overexpanded money supply year after year.

Mr. MELTZER. Let me say that I made my proposal, whatever its merits or demerits, Senator, with the caution that you suggest. What I suggested was that the Fed announce the guidelines. If you don't like 1 percent, let it be within a band or range that they think they can achieve.

First, what is the point of having them come in here in the full glare of television and reporters and all the rest to announce to the country they are going to have a growth rate—let's not take the current one—let's take 1979—3 to 6 percent, and then produce something like 7.5 percent. What point is there in that? Is there some purpose being served there? All that does is bring discredit on you and them.

The CHAIRMAN. Would you like to know what the point of it is?

Mr. MELTZER. Yes.

The CHAIRMAN. The original Humphrey-Hawkins bill was so intrusive and we watered it down in a compromise because it was going to be passed to say come up and tell us what you're going to do every 6 months. So I agree with you that it serves no useful purpose. It's a media event for Paul Volcker or any other Chairman to come up. That was simply a political compromise to gut the original Humphrey-Hawkins bill.

Mr. MELTZER. But there is a merit in giving people information. Fifty years ago when we had a gold standard, whatever its merits or demerits, it had that advantage. People had some knowledge about what the long-term rate of inflation was going to be. Now why was that important to them? My answer is this. People have to know whether they're going to invest in gold, or silver, or bric-a-brac, or collectibles, or whether they want to invest in, plant and equipment. In order to know that, they have to know something about what the inflation rate is going to be because that's going to tell them what taxes they're going to have to pay on investments they make. Under the gold standard they had that long-term cer-

tainty, and I'm not an advocate of the gold standard, but it gave them that.

Now we haven't the slightest idea what the monetary policy is going to be 1 year or 2 years from now. How can people engage in long-term investments to the same degree without that confidence? The purpose of these announcements is to give people an idea of what the Government plans for it.

Now if the hearings are not doing that, we need another mechanism. My mechanism is not nearly as incautious as you suggest. I didn't say that the Fed has to resign. I said they had to offer their resignations to the President. The President can then accept responsibility for the Fed policy and therefore be accountable for it. You're accountable for the Fed policy to your voters. They don't know all of this institutional detail. If things go bad, they blame you and they blame the President of either party. What I'm asking is that they be accountable so they also have some responsibility.

If they give the President an excuse and say, look, there was deregulation in the banking system and that's why we had to miss the target by 3 percentage points this year, he could either decide he wants to accept that and accept responsibility or he can say, look, I want to get a new Chairman who's going to be able to do a better job.

We trust the President to appoint the Secretary of Defense. We ought to trust him to appoint the Chairman of the Federal Reserve and enforce some kind of consistent policy on the Federal Reserve. If we don't, we are going to continue to have this high variability which taxes the American people.

The CHAIRMAN. Well, again, I don't disagree with you on the variability. I very much oppose the idea of politicizing the Fed and this is a modified proposal. Others want the President to have a Chairman who's term is contemporaneous with his. We have proposals to put farmers and businessmen on the Board. There are constantly 10 or 11 bills before the committee to do things to the Fed. They all have the same effect—to politicize it.

POLITICIZING THE FEDERAL RESERVE

What would have happened—and the reason I want to—even when I disagree with the Fed, and I often do—and that's why I said I agree with a good deal of your criticism I do not want to upset their independence and politicize it because it would only go one way. This President or any other President that I have seen would yield to political pressure to demand not what you're talking about—stable monetary growth and all of that—start to get into trouble and say, hey, we've got to put that money out there and flood it, and I think you would have had an incredible—Republican or Democrat—it doesn't make any difference—that would be the tendency if the Fed was under the jurisdiction or even the pressure of a President or the Congress. It would all go one way and then you would really see inflation and high interest rates.

Mr. MELTZER. But they would never have to resign if they achieved what they said. That is, there would be no change whatsoever from the present circumstances if they achieved what they said they were going to. The only case in which there would be res-

ignations or political influence would be if they didn't do what they said, in which case the President and Congress do bear responsibility. The only thing that keeps us from having a severe inflation now is that the American public doesn't like it.

The CHAIRMAN. Well, in my realm of being a professional politician, which I am, and the way I see it again work in the real world, the proposal you suggest would bring great political pressure on the Fed and that is not your intention.

Mr. MELTZER. Certainly not.

The CHAIRMAN. But the practical application is that it would, and I'd rather have the Fed performing badly by themselves than incredibly badly from the pressure of politicians. We have failed miserably. The major problem in this country is not an economic problem, but it's the economic problem caused by politics, by gutless politicians who are buying themselves back into reelection year, after year, after year without the courage to say no to anybody who wants a dime out of the Federal Treasury.

Mr. MELTZER. I believe that's a smaller part than you do, Senator, if I may say so. I think what the budget represents is the views of the American public about who pays and who receives. Since the country is very much divided on the issue of how to close the deficit, one should expect that their elected representatives would be divided also. There's something called political courage.

The CHAIRMAN. There's something called leadership, too. The representative form of government is a two-way street that you don't just stick you finger in the air and see which way the wind is blowing. That's like the guy leaned out the window of his car in the middle of a crowd and asked, "Where are you going? I want to lead you." That's what we have in Congress. I don't have any trouble going home and explaining some of these things that are controversial. I don't have any trouble explaining the social security still needs some fixing without having to cut anybody off to reduce their current pension. Simple little things like that—12 of us voted on the Senate floor to change the retirement age from 65 to 68 at the rate of 1 month a year for 12 years. That affects the guy who's 29 years of age. You could make those kind of changes in the entitlements programs very broadly over decades without hurting anybody, but you've got to have the courage to go home and say we're not cutting you now. I have been to the senior citizens center, so I can't blame it on the people as much as I can on the politicians who are more interested in reelecting themselves and doing it easily by yielding rather than trying to say, hey, there is a different way and going home and having the courage to talk about it.

Mr. MELTZER. Well, there's certainly enough blame to go around.

The CHAIRMAN. There's no doubt about that, but it primarily resides here. What I have said many, many times is that only Congress under the Constitution has the ability to appropriate money. It doesn't matter what the President recommends. If Congress really doesn't like Ronald Reagan's budget, rather than griping and trying to politicize it or making hay out of it during an election year, all they have to do is change it, junk the whole thing. We don't like a $180 billion deficit, but he's going to get it anyway. I remember the first time when he came out with a $145 billion deficit and we said, hey, that's a political deficit that isn't possible.

Now he comes out with one that's probably realistic and he's condemned that it's too big.

As you can tell, I'm not very happy with the legislative body and if I could do one thing to solve more things for this country it would be a constitutional amendment which would limit the President to one 6-year term and Senators to two 6-year terms and Congressmen to two 3-year terms, and then we'd get back to what the Founding Fathers intended, that we have a citizen legislative body, that citizens represent their constituencies during part of their lives rather than making it their lifetime means of earning their living. I think we've gotten far, far away from what they intended as a representative government. We are becoming elected bureaucrats. The only difference between us and the boys downtown is that we have to face reelection and be smart enough to con our constituents into reelecting us every 6 years, and the bureaucrats are locked in with their next closest thing to eternal life we'll ever find on this earth which is civil service, that you're not in any danger unless you so badly screw up that you're really in trouble and you get removed.

So again, I'll get back to my statement that we've got more of a political problem in this country that causes the economic problem than all the econometric models in the world will show you. We need backbone and courage from our public officials to attempt to do what's right for all rather than what it looks good for us to do during an election year.

Well, I appreciate you listening to my lecture. It's very kind of you to sit there patiently and smile. I appreciate both of your testimonies very much. Do either of you wish to make a closing statement?

[No response.]

The CHAIRMAN. Thank you gentlemen, very much.

The committee is adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

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